Supreme Court, U.S.
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IN THE

Supreme Court of the United States

BETTY R. BROWN, MICHAEL J. BROWN, PHILIP MELROSE, BERYL C. RAE, and RAYMOND C. SANDLER, as Co-Trustees of the MARITAL TRUST CREATED UNDER THE WILL OF WILLET H. BROWN,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Can a transfer of funds from a husband to a wife, which she used to pay a joint and several gift tax liability elected under 26 U.S.C. 2513(a), be disregarded under the step transaction doctrine where the payment created an irrevocable estate tax consequence if the wife died within three years; husband and wife had no control over the estate tax consequences of the transactions; and no tax liability was avoided at the conclusion of the transactions?

PARTIES TO THE PROCEEDING

All of the parties to the proceeding are named in the caption. Petitioners Betty R. Brown, Michael J. Brown, Philip Melrose, Beryl C. Rae and Raymond C. Sandler, are individuals acting in their capacities as co-trustees of the Marital Trust created under the Will of Willet H. Brown. No corporation is a party to the proceeding or has an interest in the proceeding.

The only defendant is the United States of America.

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PETITION FOR WRIT OF CERTIORARI

Petitioners hereby respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

DECISIONS BELOW

The Order and Opinion of the United States Court of Appeals for the Ninth Circuit in *Betty R. Brown, et al. v. United States of America*, Case No. 02-55254 was filed May 1, 2003 (Appendix A). The slip opinion runs from page 5739 to page 5773. The opinion was published at 329 F.3d 664 (9th Cir. 2003). An unofficial citation is 2003 W.L. 1989618.

The Order Denying Defendant's Motion to Amend Final Judgment entered in the United States District Court for the Central District of California in the case of *Betty R. Brown, et al. v. United States of America*, Case No. CV-99-05437-GAF, filed December 7, 2001 (Appendix B) was not published.

The Judgment and Order of the United States District Court, in the case of *Betty R. Brown, et al. v. United States of America*, Case No. CV-99-05437-GAF, filed October 25, 2001, entered October 26, 2001, (Appendix C) was not published.

The Findings of Fact and Conclusions of Law of the United States District Court in the case of *Betty R. Brown, et al. v. United States of America*, Case No. CV-99-05437-GAF was filed October 3, 2001, and entered October 4, 2001 (Appendix D). It was not published in the official reports, but was published at 88 AFTR.2d, 2001-6665.

The Order Regarding Cross Motions for Summary Judgment on Plaintiffs' Motion for Order Pursuant to F.R.C.P. 54(d) in the case of *Betty R. Brown v. United States of America*, Case No. CV-99-05437-GAF was filed and

entered by the United States District Court on June 29, 2000 (Appendix E); it was not published.

JURISDICTION

The judgment of the United States Court of Appeals for the Ninth Circuit was entered May 1, 2003. There has been no request for an order respecting a rehearing.

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

26 U.S.C. 2035(c)

> **Inclusion of gift tax on certain gifts made during 3 years before decedent's death.**—The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death.

26 U.S.C. 2513(a)

> **(a) Considered as made one-half by each.—**
>
> **(1) In general.**—A gift made by one spouse to any person other than his spouse shall, for the purposes of this chapter, be considered as made one-half by him and one-half by his spouse, but only if at the time of the gift each spouse is a citizen or resident of the United States. This paragraph shall not apply with respect to a gift by a spouse of an interest

in property if he creates in his spouse a general power of appointment, as defined in section 2514(c), over such interest. For purposes of this section, an individual shall be considered as the spouse of another individual only if he is married to such individual at the time of the gift and does not remarry during the remainder of the calendar year.

(2) Consent of both spouses.— Paragraph (1) shall apply only if both spouses have signified (under the regulations provided for in subsection (b) their consent to the application of paragraph (1) in the case of all such gifts made during the calendar year by either while married to the other.

26 U.S.C. 2513(d)

(d) Joint and several liability for tax.— If the consent required by subsection (a)(2) is signified with respect to a gift made in any calendar year, the liability with respect to the entire tax imposed by this chapter of each spouse for such year shall be joint and several.

STATEMENT OF THE CASE AND PROCEEDINGS BELOW

Pursuant to a Prenuptial Agreement with decedent Willet H. Brown, Betty R. Brown, maintained a separate property bank account under her control and fully disposable by her. (Order Re SJ, App. E, page 4). In 1992, the Browns created an irrevocable insurance trust which provided for a gift to the trust of $3,102,000. The Browns' estate planning attorney advised decedent that Betty, not decedent, should pay the gift taxes arising from funding of the trust. (Order Re SJ, App. E, page 5).

The Browns' attorney, Raymond C. Sandler, discussed with decedent that because he was 87, and his wife was 71, it was more probable that he would die within three years of payment of the gift taxes, than would Betty. Sandler advised decedent that whichever of the Browns paid the gift taxes, if that person died within three years, the amount of the gift taxes would be included in his or her estate. Sandler said that, by having Betty pay the gift taxes, in essence the Browns would be making an "actuarial bet" that, based solely upon their respective ages, Willet was more likely to die within three years than his wife. (Order Re SJ, App. E, page 7).

Betty did not have sufficient funds to pay the gift taxes. On April 13, 1993, Willet delivered to Betty two checks payable to her in the amounts of $1,414,000 and $1,732 with the "understanding" between the Browns that she would use that money to pay the gift tax liabilities of the Browns. The checks were deposited into Betty's personal account. On April 14, 1993, pursuant to the estate plan recommended by Sandler, Betty drew from her personal account two checks payable to the IRS for the $1,415,732 gift taxes due by reason of the $3,102,000 gift to the trust. (Order re SJ, App. E, pages 9-10).

On April 14, 1993, the Browns each filed separate United States gift tax returns, electing under § 2513(a) to treat the gifts reported therein as being made 50% by each for federal gift tax purposes. The gift tax combined liability was $1,415,732. Each was jointly and severally liable for the entire sum. (Order re SJ, App. E , page 10).

Willet H. Brown died October 14, 1993. On January 13, 1995, plaintiffs, as co-executors of the estate of Willet H. Brown filed the U.S. estate tax return reporting a gross estate of $181,801,820, with no estate taxes due or payable. The report of no estate taxes was based upon plaintiffs' understanding that the entire net estate qualified for the marital deduction under section 2056 of the IRC. (Order Re SJ, App. E, pages 10-11).

On September 26, 1997, the Superior Court of Los Angeles County rendered its Order for Final Distribution providing that decedent's residual estate be distributed to plaintiffs in their capacity as co-trustees of the Marital Trust Created Under the Will of Willet H. Brown. (Order re SJ, App. E, page 11).

On January 5, 1998, the IRS sent to plaintiffs a Notice of Deficiency based upon a contention that the $1,415,732 gift taxes paid by Betty Brown were actually paid by Willet, and therefore, should have been included as a transfer during his life in accordance with 26 U.S.C. 2035(c). (Order re SJ, App. E, page 11). After payment of estate taxes and interest by plaintiffs, and a partial refund by the IRS, plaintiffs had paid $1,474,664 in estate taxes and $549,850 in interest, a total of $2,024,514 (Order re SJ, App. E, pages 11-12).

On October 13, 1998, plaintiffs filed a Claim for Refund and Request for Abatement with the IRS, claiming a refund of $2,024,514, plus interest according to law. After more than six months elapsed from the time plaintiffs filed their claim for refund, having received no response from the IRS,

plaintiffs filed their complaint in this action on May 25, 1999. (Order re SJ, App. E, page 12).

The basis of jurisdiction of the United States District Court for the Central District of California was 28 U.S.C 1346(a)(1). The matter involves a federal question, and the United States is a party.

Plaintiffs' First Claim for Relief was for recovery of $2,024,514 of estate taxes and interest erroneously or illegally collected. It was based upon the contention that the IRS had erroneously determined that the gift taxes had been paid by decedent rather than Betty R. Brown. (Order re SJ, App. E, page 13).

The Second Claim for Relief sought an offset to the asserted deficiency for $1,712,024.03 of administrative expenses actually incurred in excess of those claimed on the estate tax return. The Third Claim for Relief sought a refund based upon interest paid on the estate tax deficiency, without reduction of the marital deduction, in accordance with Revenue Ruling 93-48. (Findings, App. D, pages 18-19). *Neither of these Claims for Relief is the subject of this petition.*

On April 4, 2000 and May 22, 2000, plaintiffs and defendant filed cross-motions for summary judgment on plaintiffs' First Claim for Relief. On June 29, 2000, the District Court issued its Order Regarding Cross Motions for Summary Judgment and Plaintiffs' Motion for Order Pursuant to F.R.C.P. 54(b) (App. E). The District Court granted summary judgment to defendant on plaintiffs' First Claim for Relief, ruling that the gift taxes were in fact paid by decedent Willet H. Brown, despite their having been paid by Betty from her separate property account with funds which were an unrestricted gift from Willet. The District Court ruled that the gift taxes were properly deemed paid by Willet because his funds were the source of the payment, and the funds were delivered to Betty pursuant to an understanding that their

attorney's estate planning advice would be followed. (Order re SJ, App. E, pages 15-20).

Trial on plaintiffs' Second and Third Claims for Relief was conducted on June 19 and 20, 2001. On October 3, 2001, the District Court issued its Findings of Fact and Conclusions of Law (App. D).

On October 26, 2001, the District Court entered judgment in favor of defendant on plaintiffs' First Claim for Relief (App. C). (The District Court also entered judgment in partial favor of plaintiffs on plaintiffs' Second Claim for Relief and in favor of plaintiffs on plaintiffs' Third Claim for Relief). On November 9, 2001, defendant filed a motion to alter or amend the judgment. On December 6, 2001, the court issued its order denying the motion. (App. B). On January 31, 2002, plaintiffs filed a Notice of Appeal from the court's judgment denying plaintiffs' First Claim for Relief and from that portion of the judgment denying plaintiffs' Second Claim for Relief for excess administration expenses charged to principal of the marital trust.

On May 1, 2003, the United States Court of Appeals for the Ninth Circuit issued its opinion and judgment affirming the judgment of the District Court. The Court of Appeals did not decide whether the scope of review of a District Court's summary judgment applying the step transaction doctrine to impose tax liability was clearly erroneous or de novo. The Court of Appeals stated: "As it turns out, it would not matter, as we would on this record affirm the district court's summary judgment determination applying a de novo standard." (App. A, page 11).

The Court of Appeals found: "[i]n the context of the step transaction doctrine" (App. A, page 13) that "Betty was a 'mere conduit' of Willet's funds." (App. A, page 14).

The Court of Appeals ruled it was irrelevant to application of the step transaction doctrine that Willet and Betty had elected pursuant to §§ 2513(a) and (d) to treat the

gift to the insurance trust as a split gift, which created a joint and several gift tax liability (App. A, page 16). The Court of Appeals stated: "Only if Betty pays the gift tax by using her own financial resources is her estate reduced, such that her estate should bear the risk that the payment be included in her estate via §2035(c)(1993)." (App. A, page 17).

The Court of Appeals ruled it was irrelevant that if Betty had died within three years of the gift tax payment, her estate would have suffered the estate tax liability under § 2035(c) (App. A, page 20).

REASONS FOR GRANTING THE PETITION

The issue presented by this petition is *not* the common question of whether the facts of a particular transfer meet one or more of the tests for application of the step transaction doctrine. The important question of federal law raised by the petition, which has never been decided, is *whether § 2513(a) authorizes spouses to allocate the risk of which one of their estates may incur an estate tax liability under § 2035(c) for gift taxes paid within three years of death.* By allowing spouses to elect to have a gift tax liability incurred by one of them treated as a joint and several liability under § 2513(d), Congress enacted a policy allowing spouses to allocate that estate tax risk.

The Court of Appeals recognized that if 71 year old Betty had died first, the gift taxes she had paid would have been brought back into her estate and created a tax liability (App. A, page 20). The Court of Appeals nevertheless applied the step transaction doctrine, ignoring that the Browns had irrevocably created the possibility of an adverse tax consequence, over which they had no control.

Congress, by enacting § 2513(a), allowed spouses to create a *fictional state of affairs* concerning gifts by one of them. A logical implication of that statute is to allow a

husband to transfer funds to his wife for the purpose of paying the joint and several liability created by that fiction. If the husband and wife are entitled to gift tax benefits which may accrue by reason of the statutory "split-gift," they are entitled to whatever estate tax benefits may accrue from the wife's payment of her gift tax liability with funds provided by the husband.[1] Just as the "source of funds" is irrelevant to the *creation* of the gift tax liability, it is irrelevant to *payment* of the gift tax liability. The imposition of a "source of funds" criteria is not part of the statutory scheme; is not consistent with Congressional intent; and is a method of depriving spouses of their right to plan their affairs to reduce possible tax obligations. Willet could have given Betty any amount of money prior to his death, thereby reducing his estate with no possible adverse estate tax consequences. Why should it matter that Willet gave Betty money to pay a joint and several gift tax liability, as contrasted with any other debt she owed?

At App. A, page 16, the Court of Appeals said: "Had Betty truly paid the gift tax from her own funds, § 2035 would not apply to Betty's payments of the gift tax, because of § 2513." The District Court found on undisputed facts that Willet's checks had been deposited by Betty Brown into a separate property bank account "under her control and freely disposable by her." (App. E, pages 4, 10). The Court of Appeals' characterization throughout its opinion that Willet, not Betty, paid the gift tax was *not based upon actual fact*,

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[1] The Court of Appeals stated at footnote 11 (App. A, page 16): "Section 2513 applies only for purposes of the gift tax, not for the estate tax. *Estate of Flandreau v. Commissioner*, 994 F.2d 91, 93, n. 1 (2d Cir. 1993)." *Flandreau*, however, did not involve an estate tax on a gift tax payment, but a finding that promissory notes from decedent to her children were not bona fide.

rather was based upon application of the step transaction doctrine. That doctrine was created to disregard transactions of no real economic consequence which were designed to frustrate the tax policies of Congress. Far from contravening a Congressional policy, the Browns' election under § 2513(a) to create a joint and several gift tax liability, and their decision to have Betty satisfy that liability, was consistent with statutory policy.

A husband and wife have a *right* to transfer funds inter-se where no tax liability is avoided from the transfer, and the only result is to affect a risk which is totally dependent upon circumstances over which they have no control.

The issue is purely one of law. The right's application would not depend upon the fact intensive criteria of the step transaction doctrine, because the right itself precludes application of that doctrine.

The rule announced by the Court of Appeals re "source of the funds" in cases of payment of joint and several gift tax liability creates uncertainty. If a husband gives a wife an amount of money, and months later the wife pays a joint and several gift tax liability with a portion of that sum, can that payment still be included in the husband's estate if he dies within three years? How many years must the wife have had the funds before the "source" is no longer important? If a wife commingles the funds with her own, which would have been sufficient to pay the gift tax, is there a burden to trace the payment funds? What if there was a pattern of the husband making substantial monetary gifts to the wife?

The Willet Brown estate was punished because he and Betty did not attempt to obfuscate their intent. Instead, the Browns carried out a simple plan, utilizing the fact that a pre-nuptial agreement made all funds deposited in Betty's account her separate property. They intended only to *reduce the chances* that an estate tax might become payable on the gift tax payment. If the Browns had a right to implement the plan

to reallocate the risk, the details as to how and when Betty received the funds from Willet should not be a subject of concern by the government.

At App. A, page 5754, the Court of Appeals mistakenly said: "The Browns do not advance any argument that the payment to Betty had any purpose or effect other than as a step toward facilitating Willet's payment of the gift tax liability, and Betty owned Willet's funds for exactly one day." On the contrary, petitioners consistently argued that the purpose was to have Betty make the payment of the joint and several gift tax liability from *her funds*; that whether those funds came to her by way of an "understanding", and were in her possession for only one day, was legally irrelevant. There was never a contention by the government that Betty did not have legal control over monies deposited in her separate account. The only contention of the government was that that legal control should be disregarded because Betty received the money pursuant to an understanding she would use it to pay the joint and several gift tax liability.

Petitioners do not dispute there is ample authority that under the step transaction doctrine, an "understanding" can result in the collapsing of a family transaction. But in such cases, the taxpayers were attempting to avoid immediate tax consequences which would have resulted had the transaction been consummated in a more direct manner. An example is *Griffin v. United States*, 42 F.Supp.2d 700 (W.D. Tex. 1998), in which the husband and wife attempted to reduce a gift tax liability created by a transfer to a trust for the benefit of their children. The husband transferred 45% of the stock of his wholly owned corporation to his wife. Then both transferred 45% interests in the corporation to the trust. They then claimed "minority" discounts for the value of their gifts to the trust.

The Griffins manipulated funds in order to reduce a gift tax liability which would have immediately resulted if the gift

had been made solely by the husband. The Browns did not attempt to reduce their gift tax liability. The Browns were attempting only to improve the actuarial risk of whether any estate tax liability would be created because of the subsequent death of one of them within three years. No tax liability was avoided at the conclusion of Willet's transfer of funds to Betty and her payment of the gift tax.

Petitioners acknowledge there is no conflict among the Circuits as to whether the step transaction doctrine can be applied where spouses have utilized the statutory election to create a joint and several gift tax liability, the husband transferred funds to the wife to satisfy that liability, and the wife paid the gift taxes. *The case is one of first impression, but it is of wide import.* Many estate planners utilize the "split-gift" created by Congress under § 2513(a). Estate planners throughout the country will be dissuaded by reason of the Court of Appeals' opinion from exercising the spouses' right to allocate the risk of an increased taxable estate by reason of § 2035(c). The Court of Appeals' decision, if it remains extant, deprives taxpayers of their right to plan their affairs so as to minimize their exposure to estate tax liability.

The Browns had no control over the estate tax consequences of their transaction. Had Betty died first, as a result of the Browns' election under § 2513(a), her taxable estate unquestionably would have been increased by the amount of her gift tax payment. At App. A, page 20, the Court of Appeals considered a hypothetical situation of Betty dying first. The Court of Appeals, however, analyzed that situation in the context of Betty's estate trying to disavow the fact that she had paid the gift taxes. In that discussion, the Court of Appeals turned petitioners' argument on its head. Petitioners maintained that exactly because Betty's estate could *not* have disavowed the transactions, and because her estate *was exposed* to a risk of being increased by the gift tax payment, no step transaction analysis was appropriate.

At App. A, page 19, the Court of Appeals cited *Estate of Sacks v. Commissioners,* 856 F.2d 1158 (8th Cir. 1988) and *Robino Inc. Pension Trust v. Commissioner*, 894 F.2d 342 (9th Cir. 1990) for the proposition that lack of certainty of a tax benefit from the transaction did not preclude application of the step transaction doctrine. Again, the Court of Appeals missed the point. Petitioners were contending that *creation of a possible adverse tax consequence*, not the lack of certainty of a tax benefit, was the important point.

In *Sacks*, supra, the donee trust contracted to pay a tax on a gift, which was considered by the court to be a "net gift." The contract between the donor and the trust could have created a tax advantage only if the donor died within three years, but there was no downside. Unlike the Browns, the trust had no exposure to any liability for an estate tax.

In *Robino Inc. Pension Trust v. Commissioner*, supra, the taxpayers sold property to the pension trust, which immediately sold it to a third party for substantial gain. The agreement with the trust allowed the taxpayers to keep the parcel if it did not appreciate in value, but shifted gain on the parcel to the trust if it did increase in value. (894 F.2d at 345) There was no downside, and the taxpayers had complete control over the tax consequences of their transactions. *Robino* was a classic one-way street, totally unlike the situation in this case.

Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983) cited by the Court of Appeals (App. A, page 12) involved an attempt to achieve the certain result of avoiding an immediate tax consequence which would have occurred but for the transaction structured by the taxpayer. Unlike the Browns' transactions, the result in *Stewart* was completely under the control of the parties.

Petitioners urge the Court that the absence of a conflict should not result in rejection of the petition. The lack of reported cases does not mean that many estate planners have

not considered creating a potential adverse tax consequence to reallocate the risk of inclusion of gift taxes paid pursuant to an election under § 2513(a). The Court of Appeals' decision will chill the taxpayers utilization of the split-gift election authorized by Congress, despite the willingness of parties to accept the irrevocable consequences of one spouse's paying the gift taxes. The Court of Appeals' imposition of a source of funds requirement is contrary to the clear intent of Congress and should not be allowed to stand.

The Court should accept this petition to clarify the relationship between § 2513(a) and § 2035(c) of the Internal Revenue Code, as it affects estate tax liabilities for payment of joint and several gift tax obligations. The Court should accept this petition to establish that spouses do have a right to legally transfer their funds in accordance with state law solely to improve their chances of not incurring an estate tax liability. Petitioners submit that is a fundamental right, free from attack from the government under the step transaction doctrine.

CONCLUSION

The Court should grant certiorari to determine the important question of federal law raised by this petition.

DATED: July 17, 2003

Respectfully submitted,

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BETTY R. BROWN,
MICHAEL J. BROWN,
PHILIP MELROSE,
BERYL C. RAE, and
RAYMOND C. SANDLER,
as Co-Trustees of the
MARITAL TRUST CREATED
UNDER THE WILL OF
WILLET H. BROWN

APPENDIX A

FOR PUBLICATION

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BETTY R. BROWN; MICHAEL J. BROWN; PHILIP A. MELROSE; BERYL RAE, as Co-Trustee of the Marital Trust Created under the will of Willet H. Brown; RAYMOND C. SANDLER, as Co-Trustees of the Marital Trust Created Under the Will of Willet H. Brown,
Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

No. 02-55254
D.C. No. CV-99-05437-GAF
OPINION

Appeal from the United States District Court
for the Central District of California
Gary A. Feess, District Judge, Presiding

Argued and Submitted
February 4, 2003—Pasadena, California

Filed May 1, 2003

Before: Thomas J. Meskill,* Warren J. Ferguson, and Marsha S. Berzon, Circuit Judges.

Opinion by Judge Berzon

*The Honorable Thomas J. Meskill, United States Circuit Judge, United States Court of Appeals for the Second Circuit, sitting by designation.

COUNSEL

Charles L. Birke, Sandler and Rosen, LLP, Los Angeles, California, for the plaintiffs-appellants.

Judith A. Hagley, Tax Division, Department of Justice, Washington, DC, for the defendant-appellee.

OPINION

BERZON, Circuit Judge:

The estate tax combines into one sad transaction the only two certainties in life. Upon death, a decedent's estate must pay a tax on property owned immediately prior to death, subject to certain adjustments. 26 U.S.C. § 2001 *et seq.*[1]

This appeal involves three of those adjustments. First, we must determine whether the Internal Revenue Service ("IRS") properly increased the estate tax owed by the estate of Willet Brown ("the Estate") under § 2035(c)(1993), a provision which increases the estate tax to account for gift taxes paid in the three years immediately prior to death. To answer that question, we must consider whether the IRS was entitled to apply the "step transaction" doctrine, treating gift taxes paid by Betty Brown as if paid by Willet Brown. The district court determined that the IRS properly ascribed the payment of the gift taxes to Willet Brown, as do we.

The second, more complex issue involves the interaction of two estate tax deductions: the marital deduction (§ 2056) and the administration expense deduction (§ 2053(a)(2)). The Estate argues that it is entitled to increase the administration expense deduction to account for higher-than-expected administration expenses. The IRS agrees, but argues that any increase in that deduction must by offset by a corresponding

[1]All further citations are to 26 U.S.C. unless otherwise indicated. This appeal is governed by the statutes and regulations in place in 1993 when Willet died. For convenience, we cite to the current authority unless the distinction is relevant, in which case we cite the superseded authority and so note.

decrease in the marital deduction to the extent that expenses were paid out of funds otherwise earmarked for the marital trust. The district court ruled in favor of the IRS. We affirm on that issue as well.

BACKGROUND

Willet Brown ("Willet") died in 1993, leaving behind a sizeable estate, worth approximately $180,000,000. Pursuant to a pre-nuptial agreement between Willett and wife Betty Brown ("Betty"), the entire estate was Willet's separate property, California community property laws notwithstanding.

(A) The Estate Tax Plan

Prior to his death, Willet sought the advice of an estate tax attorney. Together, the two developed a plan pursuant to which Willet's entire net estate would be placed in a marital trust upon his death. During her life, Betty would be the income beneficiary of this marital trust. Through the operation of the marital deduction rules of § 2056 this arrangement allowed Willet both to provide financial stability to Betty and to defer the collection of estate taxes until after Betty's death. *See Brown v. United States*, 88 A.F.T.R. 2d. 2001-6665, *1 (C.D. Cal. 2001).

As part of this plan Willet also created an insurance trust to hold life insurance on Betty's life, presumably so that the heirs receiving the estate property upon her death could use the life insurance proceeds to pay estate taxes. To fund the life insurance trust Willet gave Betty a gift of $3,100,000. Betty promptly wrote a check from her separate checking account for that amount in favor of the life insurance trust.

Whether the $3,100,000 was paid by Betty or Willet is immaterial to the current appeal. The parties agree that the $3,100,000 payment into the life insurance trust was a taxable event, incurring gift tax liability of $1,415,732. They further

agree that Willet and Betty properly elected to be jointly and severally liable for the gift taxes under § 2513(a) & (d).

At issue is whether Willet or Betty paid the gift taxes. If the spouse who paid the gift taxes died within three years of doing so, § 2035(c)(1993) would require that spouse's estate to pay estate taxes on the $1,415,732 in gift taxes.[2] As Willet died within three years of the payment, it is preferable to the estate that Betty be considered the individual who paid the gift tax.

We here pause to explain why the IRS would require a decedent to pay estate taxes on gift taxes, a concept that, on its face, gives new meaning to the phrase "double taxation." Section 2035(c)(1993) is designed to recoup any advantage gained by so-called "death-bed" transfers in which a taxpayer, cognizant of impending mortality, transfers property out of her estate in order to reduce estate tax liability. *See Block v. United States*, 507 F.2d 603, 605 (5th Cir. 1975) (discussing predecessor of the current § 2035). Although these *inter vivos* transfers incur gift tax liability, opting to transfer assets prior to death still carries a tax advantage.[3] Gift tax is calculated using a tax exclusive method (the applicable rate is applied to

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[2]When Willet died in 1993, § 2035(c) stated:

> The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death.

In 1997, this section was re-codified, with minor changes not relevant here, as § 2035(b).

[3]The discussion in the text pertains to the federal estate tax provisions prior to the 2001 Economic Growth and Tax Relief Reconciliation Act ("2001 Act"), Pub. L. No. 107-16, §§ 501-581. That act phases out the estate tax for future decedents, but with "sunset" provisions. For a discussion of these changes, none of which affect the Estate, see Charles F. Newlin & Andrea C. Chomakos, *The 2001 Tax Act: Unchartered Waters for Estate Planners*, 15-OCT Prob. & Prop. 32 (2001).

the *net* gift, exclusive of gift taxes), whereas estate taxes are calculated on a tax inclusive method (the applicable rate is applied to the *gross* estate, before taxes are deducted).[4] Section 2035(c)(1993) presumes that gifts made within three years of death are made with tax-avoidance motives and eliminates the tax advantage for those death bed transactions.

Back to our story: Willet and his attorney realized at the time of the life insurance trust transaction, that in light of §2035(c)(1993), it was a better actuarial bet for Betty, rather than Willet, to pay the gift taxes. True, if Betty paid the gift taxes and then died within three years of doing so, her estate might owe estate taxes on the gift taxes through the operation of § 2035(c)(1993). But Betty, age 71, was more likely to out-

[4]A stylized example of this effect might proceed as follows: Suppose a taxpayer had a taxable estate of $1,400,000. If the taxpayer waits to transfer the money through a post-mortem transfer, the estate tax would be calculated by applying the applicable tax rate (assume 40% for ease of calculation) to the gross amount of the estate ($1,400,000), resulting in an estate tax liability of $560,000 and a net gift to the heirs of $840,000. In contrast, had the taxpayer made an *inter vivos* gift of $1,000,000, the gift tax would be calculated by applying the applicable tax rate to the $1,000,000 gift, resulting in a gift tax liability of $400,000 (40% x $1,000,000) (In most instances gift and estate taxes are imposed at the same rate. §§ 2001(b-c); 2501(a)(1); 2502). Paying gift rather than estate taxes thus puts $160,000 more of the $1,400,000 in total funds in the pockets of the estate beneficiaries. *See* Jeffrey G. Sherman, *Hairsplitting Under I.R.C. Under Section 2035(d): The Cause and The Cure,* 16 Va. Tax Review 111, 121 & n.49 (1996) (providing similar calculations); Jeffery N. Pennell & Alan Newman, *Wealth Transfer Tax Basics*, SD85 ALI-ABA 1, 40 (1999) (same).

The tax code does not care for such manipulable results. If an *inter vivos* gift is made within three years of the decedent's death, Section 2035(c)(1993) requires that the taxable estate include the $400,000 in previously untaxed gift taxes. This mandate creates an estate tax liability of $160,000 (40% x $400,000), thereby eliminating the advantage of *inter vivos* gifts. (This example does not take account of the provisions, *discussed infra,* allowing small annual gifts (§ 2503(b)) or "split-gift" treatment between spouses (§ 2513), nor does it consider a variety of other factors which could alter the details of any particular example.)

live the 3-year reach of § 2035(c)(1993) than was Willet, age 87. A good plan, but the couple faced a practical problem: Betty had little money of her own and was therefore unable to make the necessary payments from her separate property.

So Willet, on the advice of his estate tax attorney, gave Betty two checks totaling $1,415,732, which she deposited in her own account. The next day she drew two checks from her personal account payable to the IRS for the identical amount, in satisfaction of the gift tax liability. (Because gifts between spouses are tax free, the gifts from Willet to Betty enabling this actuarial wager did not otherwise risk any gift or estate tax liability.) As the Brown estate admits, this money was given to Betty on the "understanding" that Betty would use it to satisfy the gift tax liability.[5] Betty was, however, under no legally enforceable obligation to use the funds in that fashion.

(B) The Estate Tax Return & Litigation

Willet won the actuarial bet he might have preferred to lose. He died in 1993, within three years of the gift tax payment.

In 1995, the Estate prepared an estate tax return indicating zero tax liability. The zero balance reflected: (1) the absence of any tax payment on the above-described gift tax, based on the assumption that Betty made the payment; and (2) a marital trust comprising the remaining estate (after expected administration expenses), which passed to Betty and was therefore eligible for the marital deduction.

The IRS — predictably — disagreed with the Estate's tax return. The IRS claimed that, in substance if not in form, Willet paid the gift taxes so the $1,415,732 should be included in

[5]The Estate emphasizes that "understanding" connotes a "mutual contemplation" rather than an "obligation." As we will discuss, this distinction does not change our analysis.

the Estate. In addition, as those funds did not pass to the marital trust but rather were used to benefit the beneficiaries of the life insurance trust, those funds, maintained the IRS, were not eligible for the marital deduction. The IRS consequently assessed a tax deficiency on the $1,415,732 and interest thereon.

The Estate — predictably — did not accept the IRS analysis. The executor remitted the requested sums but filed for a claim of abatement. After the IRS took no action on the abatement request, the executor filed for a rebate in 1999, raising several claims.

The Estate claims, first, that the gift taxes paid by Betty should not be included in the Estate. On cross-motions for summary judgment the district court denied that contention. Applying the "step transaction" doctrine, the district court determined that the transactions leading up to Betty's satisfaction of the gift tax liability should be treated, for tax purposes, as one integrated transaction. Using that approach, Willet becomes the taxpayer, as the gift tax payment traces back to Willet's gift to Betty of the precise amount of the tax. We agree with the district court that the gift tax payment is properly attributed to Willet.

The Estate also advances an alternative approach which, it argues, entitles it to a refund. The Estate notes that it actually incurred $3,592,024 in administration expenses, deductible from the gross estate under § 2053(a)(2). Because those expenses exceeded (by $1,712,024) the deduction the estate originally claimed for administration expenses ($1,880,000), the Estate argues that it was entitled to increase the administration expense deduction by $1,712,024. In a similar vein, the Estate argues that it is entitled to a deduction, under § 2053(a)(2), for the interest paid on unpaid estate taxes.

The IRS agrees that the Estate may deduct the additional administration expense and interest. It maintains, however,

that some of the increased deductions require a corresponding decrease in the marital deduction. In essence, the IRS argues that some of the increased expenses were paid out of funds otherwise earmarked for the marital trust, so that any increase in those expenses decreased those funds and therefore the marital deduction.

On this point the district court held, after a bench trial, that the Estate was entitled to increase the administration expense deduction. With respect to expenses related to interest paid on unpaid estate taxes, the court held, the Estate need not adjust the marital deduction. With respect to non-interest expenses, the result was more complicated: Relying on *Commissioner v. Estate of Hubert,* 520 U.S. 93, 100 (1997), which interpreted regulations, now superseded, in place at the time that Willet died, the district court determined that the answer depended on whether the funds were paid out of the income created by the marital trust or out of the trust corpus itself. To the extent that the administration expenses were paid out of income, the district court ruled, the Estate need not reduce the marital deduction. The district court determined, however, that any expenses paid from the corpus of the marital trust reduced the amount of the marital deduction.

In this appeal, the Estate challenges this final conclusion, that any administration expenses paid from the trust corpus decreased the marital deduction. The IRS does not cross-appeal the district court's finding in favor of the Estate on the interest issue, or the issue of expenses paid out of income earned by the marital trust.

STANDARDS OF REVIEW

With respect to the step transaction issue, the district court granted summary judgment in favor of the government. We ordinarily review grants of summary judgement *de novo,* to determine whether there are genuine issues of material fact

and whether the district court correctly applied the substantive law. *Oliver v. Keller,* 289 F.3d 623, 626 (9th Cir. 2002).

The Estate does not contend, however, that there is any genuine issue of material fact requiring trial. Rather, the Estate contends that the application of the step transaction to undisputed facts is a matter of law requiring our *de novo* review.

The IRS, in contrast, argues that the application of the step transaction doctrine to undisputed facts is itself a question of fact. It further contends that because the underlying facts are undisputed, we should review the district court's summary judgement ruling as we would review that court's judgment after a bench trial, applying the clearly erroneous standard to the step transaction determination.

Whether a lower court's application of the step transaction and related doctrines to undisputed historical facts is an issue of fact or law is a question over which we have struggled.[6] *See, e.g., Sacks v. Commissioner,* 69 F.3d 982, 986 (9th Cir. 1995) (noting conflicting authorities). We recently stated, however, that a lower court's "determination that several steps of a complex transaction are, under the step transaction doctrine, a single taxable transaction is a finding of fact subject to the clearly erroneous standard of review." *Custom Chrome v. Commissioner,* 217 F.3d 1117, 1121 (9th Cir. 2000).

The second link in the IRS' argument in favor of applying the clearly erroneous standard — that we treat the district court's summary judgment ruling as if it were the result of a bench trial rather than asking whether material fact issues require such a trial — is more problematic.[7] We need not,

[6]Whether we review a tax court decision or a decision of the district court, we apply the same standard. *Custom Chrome v. Commissioner,* 217 F.3d 1117, 1121 (9th Cir. 2000).

[7]*Compare Kearney v. Standard Insurance Co.,* 175 F.3d 1084, 1095 (9th Cir. 1999) (en banc) ("trial on the record, even if it consists of no

however, resolve the question regarding the proper standard of review at this juncture unless the answer would matter. As it turns out, it would not matter, as we would on this record affirm the district court's summary judgment determination applying a *de novo* standard.

The district court ruled on the marital expense deduction issues after a bench trial. Again, the Estate does not challenge any of the district court's factual findings. We review the court's legal conclusions *de novo*. *Stratosphere Litigation v. Grand Casinos, Inc.*, 298 F.3d 1137, 1142 (9th Cir. 2002).

ANALYSIS

(C) The Step Transaction

The "step-transaction" doctrine collapses "formally distinct steps in an integrated transaction" in order to assess federal tax liability on the basis of a "realistic view of the entire transaction." *Commissioner v. Clark*, 489 U.S. 726, 738 (1989); *accord Custom Chrome*, 217 F.3d at 1127. As such, the doctrine is part of the "broader tax concept that substance should prevail over form." *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991). Under these principles, the IRS argues, the two transactions which resulted in the payment of gift taxes (gift from Willett to

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more than the trial judge rereading what he has already read, and making findings of fact and conclusions of law instead of a summary judgment decision, may have real legal significance") (opinion of Kleinfeld, J.) *with Ingram v. Martin Marietta Long Term Disability Income Plan*, 244 F.3d 1109, 1114 (9th Cir. 2001) (remanding for a bench trial, "if confined entirely to the existing record[ ] would be little more than a formality") *and Wolfe v. United States*, 798 F.2d 1241, 1244 n.2 (9th Cir. 1986) *as amended by* 806 F.2d 1410 (9th Cir. 1986) (where parties stipulated to pertinent facts, appeal from district court's summary judgment ruling treated as an appeal from a bench trial, with factual findings reviewed under the clearly erroneous standard).

Betty, payment by Betty) should be collapsed into one (payment by Willet).

The substance-over-form doctrines are, however, bound by, and in some tension with, the principle, equally lauded in tax law, that "anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury." *Grove v. Commissioner,* 490 F.2d 241, 242 (2d Cir. 1973). We look to two principles to reconcile these competing concerns.

First, we attempt to distinguish between legitimate "tax avoidance" — actions which, although motivated in part by tax considerations, also have an independent purpose or effect — and illegitimate "tax evasion" — actions which have no, or minimal, purpose or effect beyond tax liabilities. *See Stewart v. Commissioner,* 714 F.2d 977, 987-988 (9th Cir. 1983)(citing Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code,* 21 How. L.J. 693, 695 (1978)).[8]

Second, we scrutinize whether the facts presented "fall within the intended scope of the Internal Revenue provision at issue." *Stewart,* 714 F.2d at 988. This second step is crucial in areas, such as estate planning, in which it is common for Congress to create, and taxpayers to exploit, various tax planning incentives. *See* Jay A. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies,* 42 B.C. L. Rev.

[8]*Stewart* applied the "substance over form" principle rather than expressly invoking the step transaction doctrine. As we have stated, however, the doctrines largely overlap. Indeed, *Stewart* analyzed a situation which is a typical trigger for invocation of the step transaction doctrine: A taxpayer transferred appreciated securities to a corporation he controlled. 714 F.2d at 984. The corporation sold the securities the next day and paid the majority of the proceeds back to the taxpayer. *Id.* at 984-85. We upheld the tax court's determination that the two transactions should be collapsed and treated as if the taxpayer had sold the securities directly. *Id.* at 992.

587, 599, 603-04, 615-16 (2001). For example, § 2513 allowed Willet and Betty, by exercising certain elections, to treat the underlying $3,100,000 gift from Willet to the life insurance trust as if made by both of them, when in reality Willet supplied the entirety of the funds. The IRS has never argued that the substance-over-form doctrine invalidated that election, for obvious reasons: That approach would deny taxpayers the tax benefits intentionally created by the plain language of the Code.[9]

Applying these two principles with appropriate caution, we conclude that the two-step transaction between Willet, Betty, and the IRS, was properly treated as if Willet had paid the gift taxes directly.

1. Betty As A Mere Conduit of Funds

[1] Navigating the murky distinction between "tax avoidance" and "tax evasion" requires careful stewardship. In the context of the step transaction doctrine, however, we have identified a class of cases in which the form of the transaction is particularly suspect. Where a party acts as a "mere conduit" of funds — a fleeting stop in a predetermined voyage toward a particular result — we have readily ignored the role of the intermediary in order appropriately to characterize the transaction. *Robino Inc. Pension Trust v. Commissioner,* 894 F.2d 342, 344 (9th Cir. 1990) (where taxpayers sold options on land to two trusts but the trusts acted as mere "conduits" for the ultimate sale to a third party, role of trust disregarded under step transaction doctrine); *Stewart,* 714 F.2d at 991 (where corporation acted as "merely a conduit" for the sale of appreciated securities by the taxpayer, several steps collapsed

[9]Section 2513 was enacted to equalize the ability of couples to utilize the gift tax deductions of both spouses whether the couple lived in a community property state or not. *Doerr v. United States,* 819 F.2d 162, 166 (7th Cir. 1987). The equalization effect applies only to gift tax, not to estate tax calculations. *See* note 11 *infra.*

into one under the substance-over-form principle). *See also Estate of Sachs v. Commissioner,* 856 F.2d 1158, 1163 (8th Cir. 1988) (because donor of net gift used donee as a "conduit" to pay taxes, donor deemed to have paid the gift tax).

[2] Viewing the historical facts in the light most favorable to the Estate, it is nonetheless clear that Betty was a "mere conduit" of Willet's funds. The Browns do not advance any argument that the payment to Betty had any purpose or effect other than as a step towards facilitating Willet's payment of the gift tax liability and Betty owned Willet's funds for exactly one day. Betty's fleeting ownership can therefore be disregarded under the principles of *Robino* and *Stewart.*

True, Betty was under no binding commitment to complete the prearranged plan. "Despite intimations to the contrary in the early cases," however, "there is ample authority for linking several prearranged or contemplated steps, even in the absence of a contractual obligation or financial compulsion to follow through." Boris I. Bittker, *Fed. Inc. Tax'n of Indiv.* §1.03[5] (2d. ed.). *See, e.g., Kornfeld v. Commissioner,* 137 F.3d 1231, 1235-1236 (10th Cir. 1998); *McDonald's Restaurants v. Commissioner,* 688 F.2d 520, 525 (7th Cir. 1982); *Blake v. Commissioner,* 697 F.2d 473, 481 (2d Cir. 1982). Where the two parties to the transaction were sufficiently related or commonly controlled, we have twice applied the step transaction analysis without any finding that the intermediary was legally bound to complete the prearranged plan. *See Robino,* 894 F.2d at 345 (transactions between two taxpayers and trust controlled by taxpayers and spouse of one taxpayer); *Stewart,* 714 F.2d at 984 (transaction between taxpayer and corporation he controlled).

Particularly apt is the Tenth Circuit's analysis in *Kornfeld,* applying the step transaction doctrine where, as here, family members colluded to accomplish a prearranged plan. In *Kornfeld,* the taxpayer, an experienced tax attorney, gave cash payments to his daughters and secretary. 137 F.3d at 1232-33.

The gift recipients then immediately used those funds to purchase remainder interests in bonds. *Id.* The Tenth Circuit determined that the series of transactions should be treated as if the taxpayer had purchased the bonds in fee simple and given the remainder interests to his daughters and secretary (a determination which had negative tax consequences for the taxpayer). *Id.* In so determining, the Tenth Circuit applied a heightened level of skepticism to transactions between related parties. *Id.* at 1235. In addition, the court was swayed by the facts that the "taxpayer [had] stipulated that his intention in making gifts was to enable the donees to make the purchases," and that the donees would be unlikely to flout the taxpayer's intention. *Id.* at 1236. As the court noted, "one does not look a gift horse in the mouth." *Id.*

[3] The same factors which applied in *Kornfeld* apply here: The parties are related, so heightened scrutiny is appropriate. Willet's admitted intention in giving the funds to Betty was to enable her to make the gift tax payments. Finally, Betty was unlikely to flout the desires of her husband because it was she, as the initial beneficiary of the Estate, who stood to gain if the gift tax wager was successful. The two transactions culminating in gift tax payments should therefore be treated as one integrated whole despite the lack of a legally binding commitment.

2. The End Run Around § 2035

Our conclusion is reinforced by a consideration of the statute here at issue, § 2035(c)(1993). We begin, in considering that statute, with the Eighth Circuit's analysis of a quite similar situation in *Estate of Sachs v. Commissioner,* 856 F.2d 1158 (8th Cir. 1988). In *Sachs,* Samuel Sachs gave stock in trust to his grandchildren within three years of his death. *Id.* at 1159. The gift was structured as a "net gift," meaning that the donees were legally bound to pay the gift taxes otherwise chargeable to the donor. *Id.* Relying in part on the plain language of § 2035, and in part on the substance-over-form doc-

trine, the Eighth Circuit held that "the gift tax paid under this arrangement is a 'tax paid . . . by the decedent or his estate' under § 2035." *Id.* at 1164.

The instant case differs from *Sachs*, however, in that Betty was jointly liable under § 2513(d) to pay the gift tax liability.[10] In comparison, no matter how the beneficiaries in *Sachs* received funds to pay the gift taxes, the gift tax payment was attributable to the donor, if for no other reason than because only the donor was liable for the debt owed to the IRS. *Id.* at 1163-64.

The question then is whether the Willet-Betty-IRS transaction, though on its face an end-run around § 2035(c)(1993), is nonetheless authorized by § 2513. Had Betty truly paid the gift tax from her own funds, § 2035 would not apply to Betty's payments of the gift tax, because of § 2513.[11] *Id.* at 1165. The Estate argues that because § 2513 authorizes the very "actuarial bet" the couple made, the source of Betty's funds is irrelevant.

The source of the funds *is* pertinent. *Sachs,* 856 F.2d at 1165 (because the gift tax was paid with funds from decedent's estate, fact that gift was split between decedent and his wife under § 2513 did not alter application of § 2035(c)). The language and the history of § 2035(c)(1993) emphasize that this section applies to actual gift tax payments, regardless of the relative gift tax liability among spouses.

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[10]Section 2513(d) states:

> If the consent required by subsection (a)(2) [relating to split-gift treatment] is signified with respect to a gift made in any calendar year, the liability with respect to the entire tax imposed by this chapter of each spouse for such year shall be joint and several.

[11]Section 2513 applies only for purposes of the gift tax, not for the estate tax. *Estate of Flandreau v. Commissioner,* 994 F.2d 91, 93 n.1 (2d Cir. 1993). As discussed in the text, therefore, the § 2035(c)(1993) liability is not altered by the split-gift election when the decedent in fact pays the gift taxes.

First, § 2035(c)(1993) requires that the decedent include in his estate gift taxes "*paid* . . . on any gift made by the decedent *or his spouse*." (Emphasis added). Second, the legislative history states:

> The amount of the gift tax subject to this rule would include tax paid by the decedent or his estate on any gift made by the donor . . . It would not, however, include any gift tax paid by the spouse on a gift made by the decedent within three years of death which is treated as made one-half by the spouse [*e.g.*, under § 2513], *since the spouse's payment of such tax would not reduce the decedent's estate at the time of death.*

H. Rep. No. 94-1380, *14, 94th Cong., 2d. Sess. (1976) (emphasis added).

The reason the source of funds matters is that § 2035(c)(1993) was designed to reverse the effect of funds transferred out of an estate within three years of death. If Willet pays the gift tax, it is his net worth that is reduced and therefore his estate that will escape estate tax liability on the funds if he outlives the three-year reach of § 2035(c)(1993). Accordingly, it is his estate that must reverse the effect of the transfer if he dies within the three-year period. Only if Betty pays the gift tax by using her own financial resources is her estate reduced, such that her estate should bear the risk that the payment be included in her estate via § 2035(c)(1993).

By channeling Willet's funds through Betty's estate, the Browns created a transaction sequence in which the tax risk diverged from the economics of the payment. Where one spouse has significantly fewer assets than the other spouse, shifting the risk of § 2035-inclusion onto the estate of the less wealthy spouse, while actually transferring the assets out of the estate of the more wealthy spouse, could have tax evasion advantages for the couple beyond the effect of divergent mor-

tality probabilities: The smaller estate may be subject to lower tax rates, *see* § 2001(c), or to no tax at all, *see* § 2010, so that the inclusion risk does not adequately reverse the effect of the reduction in the larger estate. We do not know whether this was the case in the Brown estate. We note the effect, however, to demonstrate that requiring, as the text and legislative history plainly do, that the § 2035 inclusion risk follow the economics of the gift tax payment is not a pointless formality. Thus, the fact that the "actuarial bet" the Browns attempted may have been proper under § 2035 and § 2513 had Betty actually paid the gift taxes does not imply that the Browns' maneuvering here was similarly appropriate.

In *Magneson v. Commissioner,* 753 F.2d 1490, 1497 (9th Cir. 1985), we distinguished between a taxpayer's right to choose "[b]etween two equally direct ways of achieving the same result" the method "which entailed the most tax advantages" and the inability to "secure by a series of contrived steps, different tax treatment than if he had carried out the transaction directly." That distinction is illuminating: Had Betty and Willet both had adequate funds with which to pay the gift tax, they would be entitled to choose the most advantageous method from among two equally direct ways of paying the tax (check from Willet to IRS vs. check from Betty to IRS). Here however, Willet actually supplied the funds, and Betty's involvement was merely a "contrived step" to secure tax treatment different from that which would have resulted if Willet had paid the IRS directly. The contrived step did not alter the economic reality that Willet paid the tax, and Betty's transient ownership over the funds for one day had no independent purpose or effect beyond the attempt to alter tax liabilities.

3. Impact of Lack of Certainty of Tax Benefit

In a variant of its assertion that the actuarial bet was entirely proper, the Estate, noting that the end result of the machinations did not create a *certain* tax advantage, contends

that the transaction sequence is therefore immune from the step transaction doctrine. That the tax advantages flowing from Willet's plan were uncertain does not, as the Estate contends, distinguish this case from other instances in which the step transaction or substance over form doctrine has been applied.

For example, in *Sachs,* Samuel Sachs' decision to route gift tax payments through his grandchildren's trust created a tax advantage only because he died within three years of the gift, such that § 2035 would apply if the gift tax payment were attributed to him. Just as Willet's actuarial bet had an uncertain payoff, Sachs' attempt to evade § 2035 could have been rendered useless by subsequent events.

Similarly, in *Robino,* we looked through the form of a transaction even though the choice of form did not create a certain tax advantage. In *Robino,* individuals devised a complicated cross-option scheme, using two trusts as conduits to hold, and ultimately sell, real property. This arrangement "let the taxpayers keep the parcel if it did not appreciate in value but shift the gain on the parcel to the trusts if it did increase in value." 894 F.2d at 345. The real estate market was "volatile" during the relevant time period, *id.* at 343, so a gain on the real property, and therefore the tax advantage of the scheme, was by no means assured. As both *Robino* and *Sachs* therefore demonstrate, a certain tax advantage is not a prerequisite to application of the step transaction doctrine.

Tax consequences aside, the nature of the Browns' transaction sequence (ultimately, a transfer of funds from Willet to the IRS) was fixed the moment Betty wrote out the check to the IRS. Focusing only on Betty's role within that predetermined result, it is clear that her participation had no significance beyond the attempt to alter tax liabilities. Unlike a situation in which Betty paid the gift taxes by reducing her own net worth, a decision with independent economic effect on Betty's estate, Betty's role as a conduit altered the eco-

nomics of the transaction *only* by shifting the risk of § 2035 inclusion from Willet's estate to Betty's estate. Where, as here, that risk shift did not reflect the reality of the underlying transaction sequence, application of the step transaction is appropriate.

The final component of the Estate's uncertainty argument relates to its complaint that the step transaction doctrine can be, and often is, applied asymmetrically: Had Betty died within three years of the gift tax payments, it is quite unlikely that the IRS would adamantly advocate in favor of treating the funds as if paid by Willet, so as to relieve Betty of the estate tax liability. The IRS's lawyer so indicated at oral argument.

The possibility of a one-way rachet does give us pause. We are not alone: Both courts and commentators have struggled with whether the substance over form principle is a one- or two-way street, and whether, even if a two-way street, it nonetheless "run[s] downhill for the Commissioner and uphill for the taxpayer." Bittker & McMahon, *Fed. Inc. Tax'n of Indiv.*, § 1.03 (quoting *Rogers' Estate v. CIR*, 70,192 P-H Memo. TC (1970), *aff'd* 445 F.2d 1020 (2d Cir. 1971)) *but see Clark*, 489 U.S. at 737 (invoking the doctrine in favor of the taxpayer). *See generally*, William S. Blatt, *Lost On A One-Way Street: The Taxpayers's Ability to Disavow Form*, 70 Or. L.Rev 381 (1991).

Had Betty indeed died first, we would be faced with the difficult question of whether symmetry required application of the step transaction doctrine, or whether the taxpayer, having complete control over the form of the transaction, must bear the consequences of the chosen form without recourse to the step transaction doctrine. Whether the doctrine must be applied symmetrically is not, however, the issue now before us, and we do not reach it.

4. Effect on Estate Planning

The Estate also maintains, somewhat grandiosely, that our holding vitiates the entire estate tax planning profession. For example, notes the Estate, a typical estate planning tool, employed by many parents, involves annual gifts of approximately $10,000 per parent in order to take advantage of the annual gift exclusion of § 2503(b).[12] Because those transactions are also motivated by a desire to avoid estate taxes, the Estate suggests, applying the substance-over-form doctrine to the instant case would require that we apply the substance-over-form doctrine to such annual gift giving and treat the gifts as if they were instead taxable estate transfers.

Rather than supporting the result the Estate favors, the *inter vivos* gift example usefully illustrates the boundaries of the substance-over-form doctrine. When parents elect to make an *inter vivos* gift to their children rather than bequeathing those assets, that decision does have effects independent of the tax consequences: The children receive the funds earlier, and the parent loses control over the assets. In comparison, Betty's ownership over the funds from Willet was transitory. She was simply a conduit, and her role in the transaction was a temporary artifice rather than an event with independent economic significance.

The *inter vivos* gift example differs from the present situation for a second reason as well. The plain language of § 2503(b) reveals that Congress intended to allow, and perhaps to encourage, small annual gifts free of tax, when it enacted § 2503(b). Otherwise, there would not be an annual dollar exclusion from the gift tax. In stark contrast, § 2035(c)(1993) discourages manipulation of the tax code by large *inter vivos* transfers, by reversing the tax benefits of

[12]Section 2503(b)(1) grants an annual exclusion of $10,000, to be adjusted for inflation as provided in § 2503(b)(2). For tax year 2002, the amount was $11,000. *See* Rev. Proc. 2001-59.

those transfers. It can hardly be argued that the purpose of § 2035 is advanced by Willet's maneuvering to create the appearance that Betty paid the gift tax when in all practical effect, Willet did so.

(B) The Marital Deduction

The Brown estate advances a second theory for relief. The Brown estate spent $3,592,024 on administration expenses (including, *inter alia,* attorneys fees, accounting fees, and legal fees), and is entitled to deduct those amounts from its estate tax return. *See* § 2053(a)(2). The Estate initially estimated that administration expenses would total only $1,712,024, and so only deducted that smaller administration expense amount when it filed its estate tax return. The Estate reasons that it is entitled to increase its § 2053(a)(2) deduction to account for the expenses actually incurred.

The IRS agrees but contends that, to the extent those additional expenses were paid out of funds otherwise earmarked for the marital trust, any increase in the administration expense deduction must be offset by a corresponding decrease in the marital deduction claimed by the Estate. To evaluate that contention, we first examine the principles governing the valuation of the gross estate, the marital deduction, and the administration deduction.

1. Calculating Estate Taxes

[4] Section 2001 of the Internal Revenue Code imposes a tax on the value of a decedent's property. In calculating the amount owed, the taxpayer first determines the value of the "gross estate." § 2031(a).

[5] From the gross estate, the taxpayer subtracts allowable deductions. Two deductions are relevant for purposes of this appeal: administration expenses, § 2053(a)(2), and amounts left to the surviving spouse, § 2056(a). The marital deduction

is limited to "property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate." § 2056(a).[13]

When administration expenses are paid out of funds otherwise earmarked for the corpus of the marital trust, the interplay between the administration deduction and the marital deduction is clear: the larger the administration deduction, the smaller the marital deduction. This is so because funds diverted from the marital trust to pay administration expenses do not "pass" to the surviving spouse. The result also makes good sense: If the estate elects the administration deduction under § 2053(a)(2), the administration expenses are thereby excluded from the taxable estate. § 2051. Including those amounts in the marital deduction as well would create a "double deduction."[14]

The plain language of § 2056(a) therefore supports the IRS position. The Brown estate, however, tries mightily to complicate matters, first by mixing and matching valuation dates, and second by relying on bits of text extracted from *Commissioner v. Estate of Hubert*, 520 U.S. 93, 100 (1997). We are not persuaded.

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[13]Section 2056(b)(7) authorizes a full marital deduction even where, as here, the surviving spouse is only an income beneficiary of the trust, with no entitlement to the underlying trust corpus.

[14]For the estates of decedents dying after December 2, 1999, the Commissioner's regulations do allow the estate to pay "management expenses attributable to the marital share" out of the corpus of the marital trust without reducing the marital deduction. 26 C.F.R. § 20.2056(b)-4(d). Any other administration expenses, such as transmission expenses (including *inter alia* executors fees and attorneys fees) paid from the marital trust reduce the marital deduction. The new regulations have no bearing on the instant appeal.

2. Timing and Valuation

The Estate urges us to value the administration expenses at two different times. For purposes of calculating the net estate after expenses and thereby determining the marital deduction, the Estate urges that we use the date-of-death value of the expenses. For purposes of calculating the § 2053(a)(2) deduction, however, the Estate urges a contemporaneous valuation approach. The result of this disparity would be to favor the Estate by allowing an increase in the administration deduction without a corresponding decrease in the marital one.

Valuing an estate for estate-tax purposes does raise difficult timing issues. The executor of an estate may need months, even years, to wind up the affairs of the estate, settle any litigation, and otherwise administer the estate. Between the decedent's death and the actual disbursal of the assets to the heirs, the estate often increases (or decreases) because the underlying assets earn (or lose) income.

Typically, the taxpayer values the gross estate according to its value on the date of the decedent's death. § 2031(a). The value of the property dedicated to any marital trust (and therefore the value of the marital deduction) is also valued as of that date. *Hubert,* 520 U.S. at 100-101; 26 C.F.R. § 20.2056(b)-(4)(a)(1993).[15] This date-of-death valuation principle has been employed in several other contexts as well. *See, e.g., Ithaca Trust Co. v. United States,* 279 U.S. 151, 154

[15]The executor can choose, in limited circumstances, an alternate valuation date for the gross estate. § 2032. If the executor chooses such an alternate valuation date, he or she must also account for certain adjustments to the marital deduction. *See* § 2032(b)(2); 26 C.F.R. §§ 20.2056(b)-4(a), 20.2032-1(1993). These alternate provisions are not pertinent to the present appeal.

Although 26 C.F.R. § 20.2056(b)-4 has undergone several revisions since 1993, the mandate in subsection (a) that the marital deduction be valued as of the date of death if the gross estate is so valued has remained consistent.

(1929) (charitable deduction valued at date of death); *Propsrta v. United States,* 680 F.2d. 1248, 1255 (9th Cir. 1982) (deduction for claims against the estate under § 2053(a)(3) valued at date of death).

This early valuation assists the executor in completing the estate tax return and in otherwise moving forward to settle the affairs of the estate. *Cf. Ithaca* 279 U.S. at 155 ("The first impression is that it is absurd to resort to statistical probability when you know the fact. But this is due to inaccurate thinking. The estate so far as may be is settled as of the date of the testator's death.") Moreover, that the heirs may ultimately receive, estate-tax free, income earned during estate administration can be considered compensation for the delay in receiving the property. *See Hubert,* 520 U.S. at 131 (Scalia, J. dissenting) (citation omitted). And, in any event, the income earned by the estate is subject to the estate's income tax. *See* § 641(a).

Whatever the valuation date, however, it is important to value the gross estate and the various deductions as of the *same* date. *Hubert*, 520 U.S. at 100-101 (Kennedy, J., plurality); 26 C.F.R. §20.2056(b)-4(a)(1993). Otherwise, an estate could value the gross estate property at its lowest point, and the marital and other deductions at their highest points, thereby gaming the resulting tax. Such gaming is, in essence, what the Estate asks this court to condone.

The administration expense deduction is an exception to the date-of-death valuation principle. If the date-of-death principle were employed, the administration expenses would be estimated as soon as practicable after the decedent's death, allowing the estate to quickly finalize its estate tax return. The gross estate would then be reduced by the expected value of the deduction and, if the expenses were to be paid out of funds otherwise earmarked for the corpus of the marital trust, the marital deduction would be reduced accordingly. Under this estimation method, an estate choosing to pay administra-

tion expenses out of funds otherwise earmarked for the marital trust would have no incentive to either under- or over-estimate. If, for example, actual expenses turned out to be more than anticipated, the estate, though it would not have benefitted from the full value of the administration reduction, would have over-estimated by a corresponding amount the funds earmarked for the marital trust, resulting in an offsetting benefit.[16]

But the IRS has adopted a different approach with respect to administration expenses. The estate may only deduct those expenses "*actually* and necessarily incurred." 26 C.F.R. 20.2053-3(a) (emphasis added).[17]

The Estate argues, correctly, that it is therefore entitled to deduct from the gross estate the amount of *actual* administration expenses. In the same breath, it further contends, incorrectly in our view, that because the marital deduction is frozen at its date-of-death value, the Estate need only reduce the marital deduction to account for marital-trust funds earmarked to pay *estimated* administration expenses.

[6] The administration expense exception to date-of-death valuation is a two-way, not a one-way, street. Because the actual, rather than expected, expenses are deducted from the gross estate (despite the usual rule that gross estate valuation is fixed at death), it follows that when those expenses are paid out of the marital trust corpus, the value of the marital trust

[16]The analysis might be more complicated, of course, for an estate that chose to pay administration expenses not from the marital trust property but rather from another source.

[17]When expenses are not yet known by the date of the estate tax filing, the estate can file an estate tax return based on estimated values. 26 C.F.R. 20.2053-1(b)(3). But the Estate asserts, and the Commissioner does not contest, that the estate can subsequently amend the return to account for actual expenses incurred. Indeed, by limiting the deduction to expenses "actually and necessarily incurred", 26 C.F.R. 2053-3(a) suggests that the estate might have a duty to amend its estate tax return in this manner.

should be reduced by the actual, rather than expected, expenses (despite the usual valuation rule). Otherwise, an estate would receive a double deduction where, as here, a taxpayer underestimates expenses, creating an incentive to do exactly that. Perhaps for this reason, the Seventh Circuit has implicitly, although not expressly, concluded that when administration expenses are paid out of marital trust property, the result is a *pro tanto* reduction in the marital deduction. *Martin v. United States,* 923 F.2d 504, 505 (7th Cir. 1991).

[7] For the reasons stated, coupled with the fact, discussed below, that the only authority on which the Estate relies supports our conclusion, we hold that § 2056 requires that, when actual administration expenses are both deducted under § 2053(a)(2) and paid out of funds otherwise earmarked for the marital trust corpus, the marital deduction must reflect the actual amount of funds so diverted.

3. Commissioner v. Estate of Hubert, 520 U.S. 93 (1997)

Hubert confronted an issue related to but different from the question presented by this appeal. That case concerned whether and how the marital deduction must be reduced when administration expenses were paid out of the *income* earned by the marital trust during estate administration, rather than from the marital trust corpus, and deducted from the estate's income tax, rather than the estate tax, return.[18]

Although that issue splintered the court, all justices recognized as established and accepted in their reasoning the proposition that when administration expenses are paid from the marital trust *corpus*, the result is a *pro tanto* reduction of the marital deduction. The plurality stated:

[18]The *Hubert* case also considered the interaction between the administration expense deduction and the charitable deduction. The opinion treated the charitable and marital deduction issues interchangeably, however, noting that the same principles guided the analysis of both. 520 U.S. at 100.

> The estate did not include in its marital and charitable deductions the amount of residue principal used to pay administration expenses. *The parties here have agreed throughout that the marital or charitable deductions could not include those amounts.* The estate, however, did not reduce the marital or charitable deductions by the amount of the income used to pay the balance of the administration expenses. The Commissioner disagreed and contended that use of income for this purpose required a dollar-for-dollar reduction of the amounts of the marital and charitable deductions.

Hubert, 520 U.S. at 99 (Kennedy, J, plurality) (emphasis added). The concurring opinion also noted:

> *Everyone agrees* that when these expenses are charged against a portion of the estate's principal devised to the spouse or charity, that portion of the principal is diverted from the spouse or charity and the marital and charitable deductions are accordingly reduced by the *actual* amount of expenses incurred.

Id. at 112 (O'Connor, J, concurring) (emphasis added). Justice Scalia's dissent, joined by Justice Breyer, likewise stated:

> Thus, as the plurality correctly recognizes, and as both parties agree, if any portion of marital bequest principal is used to pay estate administration expenses, then the marital deduction must be reduced commensurately.

Id. at 123 (Scalia, J., dissenting). *See also id.* at 136 ("the key regulation is best read to require that account be taken of *actual* expenses.") (emphasis in original).

True, those statements were not directed at the issue before the Court. Instead, each opinion recited a uniform background

assumption against which the more difficult issue of administration payments from income was to be evaluated. While these statements may be dicta under some formulations of that concept, *see United States v. Johnson,* 256 F.3d 895 (9th Cir. 2001) (debating the definition of dicta), several considerations counsel against our treating them as such. The statements were not made "casually and without analysis," *Johnson,* 256 F.3d at 915 (Kozinski, J, concurring). Rather, as we will develop, the statements formed part of the "analytical structure of the opinion," *United States v. Crawley,* 837 F.2d 291, 293 (7th Cir. 1988). Further, even if dicta, the language is still Supreme Court dicta, and dicta uniform among Justices otherwise very much divided by the case before them.

In light of the Supreme Court's statements in *Hubert*, only the most persuasive argument to the contrary would give us pause. The Estate has presented no such argument. As the district court aptly explained:

> If the Supreme Court's remarks regarding the effect of allocating administrative expenses to estate principal were truly aberrational, the Court would have expected Plaintiffs to provide authority for the contrary proposition. Plaintiffs have failed to do so, and the reason has become apparent to the Court. Taken in context, the comments of the Supreme Court reveal a unanimity on a point that, in all likelihood, is obvious in view of the controlling statute. The beneficiary may take a marital deduction to the extent that property is included in valuing the estate. Reductions in estate principal reduce the value of the estate, which in turn requires an equivalent reduction in the marital deduction. Thus, to ignore the uniform comments of the three opinions as dicta is to ignore the command of the very statute that created the marital deduction in the first place.

Brown, 88 A.F.T.R. 2d. 2001-6665 at *11.

The Estate primarily relies on the plurality opinion in *Hubert*. As stated, *Hubert* grappled only with the question whether administration expenses paid from income earned by the marital trust affected the amount of the marital deduction. In answering that question, the plurality opinion first noted that the marital deduction must be reduced to the extent that the obligation to pay administration expenses reduced the date-of-death value of the marital trust property. *Id.* at 100 (citing § 2056(a)). The question was how to calculate any resulting reduction in value. *Id.*

Relying on regulations then in force, the plurality concluded that the estate need only account for "material" reductions in the anticipated income stream produced by the corpus of the marital trust. *Id.* at 105 (relying on 26 C.F.R. §2056(b)-4(a) (1996), which stated that "in determining the value of the interest in property passing to the spouse, account must be taken of the effect of any material limitations upon her right to income from the property.") In determining "materiality," the plurality elected to employ a date-of-death valuation method, based on the expected value of future administration expenses.

The Estate argues that this valuation principle applies equally to the present case. Portions of the plurality opinion could be read in isolation to support this approach. *Id.* at 108 (marital bequest valuation inquiry limited to "facts on the controlling valuation date.") A close look, however, reveals that the plurality's overall reasoning and adoption of the present value approach in *Hubert* cannot extend to the result the Estate seeks in this case.

In determining that its valuation approach would not create a "double deduction," the plurality relied on its observation that income earned by the marital deduction was not separately included in the date-of-death value of the marital property in the first place. *Id.* at 110-111 ("The marital . . . deduction . . . do[es] not include income, however. When

income is used . . . to pay administration expenses, this does not require that the estate tax deductions be diminished.")

The plurality's conclusion was based on the observation that the marital deduction includes only asset values. *Id.* Those asset values are "determined with reference to expected income." *Id.* Because "only anticipated, not actual, income is included in the gross estate," the plurality reasoned, "only anticipated administration expenses payable from income, not the actual ones, affect the date-of-death value of the . . . bequest[ ]." *Id.* at 108. In other words, as income is only valued through the lens of expected values in the first instance, the plurality reasoned, limitations on income should be valued through that same lens.

Unlike income earned by the marital trust, the underlying assets which form the corpus of the marital trust property are, of course, directly included in the date-of-death value of the marital trust. So the rationale underpinning the plurality's conclusion that its approach created no double deduction cannot extend to the situation in which administration expenses are paid from the trust corpus and the actual amounts paid deducted under § 2053(a)(2), thereby retroactively reducing the estate date-of-death value. In this case, therefore, "capping" the marital deduction at the "value . . . included in determining the value of the gross estate," *id.* at 100-101, requires that the marital deduction be symmetrically reduced.

Certainly, the plurality's distinction between income and principal was not uniformly accepted. The dissenting justices believed that the distinction was a matter of bookkeeping without economic substance.[19] *Id.* at 133 (Scalia, J,. dissent-

[19]The Estate goes further, noting that paying administration expenses out of the trust corpus deprives Betty of only the present value of the income which the principal would generate, thereby reducing her income rights *less* than would result from a direct charge to income. As the district court persuasively explained, however, for purposes of the marital deduc-

ing); *id.* at 140 (Breyer, J., dissenting). But those justices advanced that argument in order to *criticize* the plurality's valuation approach, not to extend it. *Id.* at 136 (Scalia, J., dissenting) ("the key regulation is best read to require that account be taken of *actual* expenses") (emphasis in original); *Cf. id.* at 141 (Breyer, J., dissenting) (dollar-for-dollar approach may be reasonable).[20] The concurring opinion likewise criticized the plurality's valuation approach, albeit for different reasons. *Id.* at 115-116 (O'Connor, J., concurring) (stating that expected value principles had "questionable value in this context.").[21]

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tion, the "property which passes or has passed from the decedent to his surviving spouse" is valued as if it were a transfer in fee even when the spouse is only an income beneficiary. *See Brown*, 88 A.F.T.R. 2d 2001-6665, *12 (C.D. Cal 2001). When administration expenses are paid out of the marital trust corpus, the marital deduction is reduced not because of Betty's right to income but because of the direct effect on the value of the underlying assets which comprise the marital trust.

[20]In their respective dissents, both Justice Scalia and Justice Breyer hinted that although actual, rather than expected, values should be employed to reduce the marital deduction, the actual values should perhaps be discounted to reflect the time value of money. *See id.* at 138 (Scalia, J. dissenting); *id.* at 141 (Breyer, J. dissenting). As the Brown estate has not advanced this separate argument, we do not reach it.

[21]The concurring opinion did agree with the plurality on a different point. Focusing on the phrase "account must be taken of the effect of any material limitation upon her right to *income* from the property" found in the applicable regulation, *id.* at 117 (emphasis added), the concurring opinion agreed that the marital deduction need only be adjusted when the payment of administration expenses was a "material" limitation on income. The ensuing discussion, however, makes clear that the materiality requirement adopted by the concurrence applies only when administration expenses are paid from income:

> Revenue-Ruling 93-48 indicates [the Commissioner's] rejection of the notion that *every* financial burden on a marital bequest's postmortem *income* is a material limitation warranting a reduction in the marital deduction. That the Ruling purports to apply not only to *income* but also to *principal*, and *may therefore deviate from the accepted rule regarding payment of expenses from principal*, see *supra*, at 1134, does not undercut the relevance of the Ruling's implications as to *income*.

Id. at 119 (emphasis added).

[8] In summary, the concurring and dissenting opinions, representing a majority of the court, expressly disavowed the valuation approach adopted by the plurality, and the plurality's reasoning does not extend to the case before us. The only authority relied on by the Estate thus contradicts the result it urges. Further, the clear statutory command of § 2056 requires that the marital deduction be reduced *pro tanto* when funds previously earmarked for the marital deduction are spent on administration expenses and deducted under § 2053(a)(2).

CONCLUSION

For the reasons stated, we **AFFIRM.**

APPENDIX B

APPENDIX E

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

Civil Minutes - General

ENTERED ON ICMS
DEC - 7 2001
CV (initials)

Case No. CV 99-05437 GAF (JWJx)
Title: Brown v. United States
Date: December 6, 2001

The Honorable Gary Allen Feess, Judge

Marilynn Morris	None Present
Courtroom Deputy Clerk	Court Reporter

Attorneys Present for Plaintiffs:
None Present

Attorneys Present for Defendants:
None Present

Proceedings: (In Chambers)

The Government moves under Federal Rule of Civil Procedure 59(e) to amend the final judgment in this case. Having carefully reviewed the Government's argument, the Court finds it worthy of only brief comment.

"A motion for reconsideration under Rule 59(e) 'should not be granted, absent highly unusual circumstances, unless the district court is presented with newly discovered evidence,

committed clear error, or if there is an intervening change in the controlling law.'" *McDowell v. Calderon*, 197 F.3d 1253, 1256 (9th Cir. 1999) (*quoting 389 Orange St. Partners v. Arnold*, 179 F.3d 656, 665 (9th Cir. 1999)). The Government contends the Court committed clear error by (1) granting judgment in Plaintiffs' favor on their second claim for relief instead of granting judgment "partially in favor of Plaintiffs and partially in favor of [the Government]," because Plaintiffs did not "fully prevail[ ]" on this claim and (2) ordering the Government to calculate the "refund" owed Plaintiffs instead of the "overpayment" Plaintiffs made. (Mot. at 5,8). Neither claim has any merit.

1. Judgment Was Properly Rendered for Plaintiffs on their Second Claim for Relief

It is difficult to conceive of a less substantive objection the Government could make than its claim that the Judgment, which currently states "Judgment is granted in favor of Plaintiffs and against Defendant on Plaintiffs' Second Claim for Relief," should be amended to state, "Judgment is granted partially in favor of Plaintiffs and partially in favor of Defendant, and judgment is granted partially against Plaintiffs and partially against Defendant." (Mot. at 5). The current language accurately reflects that Plaintiffs have prevailed on their second claim for relief by demonstrating that the $67,246.03 in excess administrative expenses charged to principal is deductible. Although Plaintiffs did not succeed in proving they were entitled to the full amount they sought, they have "prevailed" on their claim. Moreover, as Plaintiffs point out, whether they are deemed to be "prevailing parties" is irrelevant and the language has no substantive import since the Court has already ordered the parties to bear their own costs and fees. For these reasons, the Government's first requested change is **DENIED**.

2. Computation of Refund

The Government's argument in support of its second requested change resembles a parlor trick in which a magician chants a few nonsensical phrases before producing a bouquet of flowers out of thin air. The Government contends that the Judgment, which currently states "Defendant shall forthwith calculate and pay to Plaintiffs the amount of the refund they are owed. . . .[,]" should instead provide that it must "direct the scheduling of an overpayment." (Mot. at 8). As authority for this requested change, the Government (1) quotes the Judgment, (2) quotes its Answer, (3) quotes the Pre-Trial Conference Order, (4) quotes its Amended Memorandum of Contentions of Facts and Law and then concludes "[t[he Court thereby erred in indicating that Plaintiffs are entitled to a refund." (Mot. at 8).

The gist of the government's argument is that before it "refunds" any portion of the money Plaintiffs paid under the notice of deficiency, it is entitled to credit that "overpayment" against any existing tax deficiencies Plaintiffs owe; therefore, any judgment ordering a refund is premature. 26 U.S.C. §6402. Plaintiffs object that section 6402 is inapplicable when a taxpayer has obtained a judgment against the Government and the entire overpayment should therefore be returned. *See Snyder v. United States*, 630 F. Supp. 182 (D. Md. 1986) (recognizing split of authority on issue).

The Court need not resolve this dispute through this motion as the question is not ripe for review. Since neither party has offered any evidence showing that Plaintiffs have any outstanding tax liabilities and the Government has not yet made any offset pursuant to section 6402, an order permitting or prohibiting the Government from doing so would amount to an advisory opinion based on a hypothetical set of facts

which may, or may not, exist. The Judgment, as written, orders the Government to "calculate and pay to Plaintiffs the amount of the refund *they are owed*" pursuant to the parties' prior stipulation. (October 25, 2001 Judgment at ¶4 p. 2 (emphasis added)). The Government should complete this calculation forthwith and pay to Plaintiffs any refund it believes they are owed based on the Court's Findings of Fact and Conclusions of Law. The Judgment need reflect nothing more and any disputes which arise between the parties as a result of the Government's calculations should be addressed *after* such calculations have been made. Accordingly, the Government's second requested change is **DENIED**.

For the foregoing reasons, Defendant's motion is **DENIED**.

IT IS SO ORDERED.

APPENDIX C

C-1

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

ENTERED
CLERK, U.S. DISTRICT COURT
OCT - 26 2001
CENTRAL DISTRICT OF CALIFORNIA
BY /s/ (initials) DEPUTY

FILED
CLERK, U.S. DISTRICT COURT
OCT - 25 2001
CENTRAL DISTRICT OF CALIFORNIA
BY /s/ (initials) DEPUTY

BETTY BROWN, et al.;

Plaintiffs,

v.

UNITED STATES OF AMERICA;

Defendant.

NO. CV 99-05437 GAF (JWJx)

JUDGMENT

✓ Docketed
✓ Copies / NTC Sent
No JS - 5 / JS - 6
___ JS - 2 / JS - 3
___ CLSD

Pursuant to the Findings of Fact and Conclusions of Law entered on October 3, 2001, and the orders referred to therein, JUDGMENT IS GRANTED in the above-entitled case as follows:

1. Plaintiffs' First Claim for Relief

Judgment is granted in favor of Defendant and against Plaintiffs' pursuant to the Court's Order Regarding Cross-Motions for Summary Judgment and Plaintiffs' Motion for Order Pursuant to Federal Rule of Civil Procedure 54(b), entered on June 28, 2000.

2. Plaintiffs' Second Claim for Relief

Judgment is granted in favor of Plaintiffs and against Defendant on Plaintiffs' Second Claim for Relief. With respect to the $1,644,077.19 in excess administrative expenses claimed by Plaintiffs which was charged to *principal*, the Court concludes that even if those expenses were deductible they would result in a dollar-for-dollar reduction in the marital deduction and would thus have no effect on the estate's tax liability. The Court concludes that the remaining $67,246.03 in excess administrative expenses charged to *income* were necessary and reasonable, are deductible on the estate tax return, and do not reduce the marital deduction.

3. Plaintiffs' Third Claim for Relief

Judgment is granted in favor of Plaintiffs and against Defendant on Plaintiffs' Third Claim for Relief. Plaintiffs are entitled to a refund based upon the $630,446 in interest paid by the estate ($549,850 to the Internal Revenue Service and $80,596 to the State of California) which is deductible as an administrative expense on the estate tax return, and does not

reduce the marital deduction.

4. Computation of Refund and Interest Thereon

Pursuant to the stipulation of the parties, Defendant shall forthwith calculate and pay to Plaintiffs the amount of the refund they are owed including any interest provided for by law.

5. Attorney's Fees and Costs

Each party shall bear its own attorney's fees and costs.

DATED: October 25, 2001

/s/ Gary Feess
Judge Gary Allen Feess
United States District Court

APPENDIX D

D-1

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

ENTERED
CLERK, U.S. DISTRICT COURT
OCT - 4 2001
CENTRAL DISTRICT OF CALIFORNIA
BY /s/ (initials) DEPUTY

FILED
CLERK, U.S. DISTRICT COURT
OCT - 3 2001
CENTRAL DISTRICT OF CALIFORNIA
BY /s/ (initials) DEPUTY

BETTY BROWN, MICHAEL J. BROWN, PHILIP A. MELROSE, BERYL RAE and RAYMOND C. SANDLER, as Co-Trustees of the MARITAL TRUST CREATED UNDER THE WILL OF WILLET H. BROWN;
Plaintiffs,

v.

UNITED STATES OF AMERICA;
Defendant.

NO. CV 99-05437 GAF (JWJx)

FINDINGS OF FACT AND CONCLUSIONS OF LAW

✓ Docketed
✓ Copies / NTC Sent
No JS - 5 / JS - 6
___ JS - 2 / JS - 3
___ CLSD

Plaintiffs Betty Brown, Michael Brown, Philip Melrose, Beryl Rae, and Raymond C. Sandler, as co-trustees of a marital trust created by decedent Willet H. Brown ("Willet"), bring this action against the Internal Revenue Service ("IRS" or "Defendant") seeking a refund of estate taxes assessed against Willet's estate. The following sets forth the Court's Findings of Fact and Conclusions of Law following a Court trial this past June.

I.
INTRODUCTION AND OVERVIEW

Betty and Willet Brown married in 1948. Through a pre-nuptial agreement, they chose to treat their respective property, then-owned and after-acquired, as separate property. During the course of their marriage, which lasted until Willet's death in 1993, Willet accumulated as his separate property an estate valued at approximately $180 million at his death. The estate prepared and filed an estate tax return indicating that no estate taxes were due and owning because of the application of the marital deduction rules set forth in Internal Revenue Code Section 2056 and related regulations. These rules provide that when the first member of a married couple dies, the decedent's total gross estate may be reduced by the value of property which is included within the estate and bequeathed to the surviving spouse. Thus, if the surviving spouse is granted the entire estate, the estate owes no estate tax. In this way, the marital deduction protects the financial stability of the surviving spouse by deferring the collection of estate taxes until the surviving spouse's death.

A. THE ALLEGED UNDERPAYMENT OF TAXES

Some time after the estate tax return was filed, the IRS concluded that Willet's estate owed taxes resulting from a

pre-death transaction with Betty in which Willet and his advisors created an insurance trust to purchase and hold life insurance on Betty's life, presumably for the purpose of paying estate taxes upon her death. Because Betty had no significant assets of her own, Willet gave Betty a gift of approximately $3,100,000, which was deposited into Betty's separate checking account. With those funds, Betty in turn wrote a check on her account for $3,100,000 and donated it to the insurance trust which used the funds to buy a $10 million insurance policy on Betty's life.

The gift to the trust was a taxable event. Because gift taxes paid by a donor within three years of the donor's death are included in the donor's estate, Willet and his advisor devised a strategy for having Betty pay the gift taxes, making, in their terms, an "actuarial bet" that it was more probable that Betty would survive three years than would Willet. Thus, Willet made a second transfer of funds to Betty in the amount of $1,415,732, which she in turn used to pay the gift taxes. Some months after these transactions were consummated, Willet died.

B. The Dispute With The IRS

Not surprisingly, a dispute ensued with the IRS over who really paid the gift taxes. The IRS took the position that the $1,415,732 in gift taxes should have been included in Willet's estate because, in reality, he paid the gift taxes using Betty as a conduit. Furthermore, since that $1,415,732 "asset" was not transferred to Betty as part of Willet's bequest, the IRS claimed that it was not subject to the marital deduction and that its inclusion in the estate gave rise to a tax liability. The IRS issued a Notice of Deficiency and sent the estate a bill for unpaid taxes and interest.

After the estate paid the bill, Plaintiffs filed this suit seeking a refund. Earlier in this litigation, the parties filed cross-motions for summary judgment on the issue regarding payment of gift taxes. Plaintiffs argued that Betty, and not Willet, paid the gift taxes. The Court, however, agreed with the IRS, and concluded that in substance (if not form) the transaction revealed that Willet had paid the taxes. That ruling, however, did not resolve the dispute.

C. THE ADMINISTRATIVE EXPENSE OFFSET

Having lost their first argument, that the $1,415,732 should not be included in Willet's estate, Plaintiffs seek at least a partial refund of the payments made to the IRS on two additional grounds. First, Plaintiffs contend that the amount of any tax deficiency should be offset by excess expenses incurred in administering the estate. They argue that actual administrative expenses exceeded the estimated expenses claimed on the original estate tax return by an amount that exceeds the alleged tax deficiency. Thus, Plaintiffs seek a determination that the estate should not have been required to pay any estate taxes.

The IRS disputes this contention. According to the IRS, recent Supreme Court precedent teaches that when excess administrative expenses are charged against marital bequest principal, this results in a corresponding reduction of the marital deduction. With respect to those administrative expenses charged to income, the IRS argues that those expenses also reduce the value of the marital deduction, as they constitute a "material limitation" on Betty Brown's right to receive income from the property. Thus, the IRS concludes that the excess administrative expenses – even if necessarily and reasonably incurred – have no effect on the estate's

overall tax liability.[1]

D. THE INTEREST EXPENSE OFFSET

Plaintiffs also contend that applicable revenue rulings hold that the estate's payment of interest to the IRS and to the State of California – a total of $630,436 – on its tax payments should be allowed as an administrative expense without reducing the marital deduction. The IRS disagrees. The IRS contends that the estate did not defer paying taxes, but was forced to pay following the IRS' Notice of Deficiency. Further, the IRS argues that, even if the law does not recognize a distinction between deferred and delinquent payments, the interest paid in this case should reduce the marital deduction because those payments constituted a material limitation on Betty's bequest. More specifically, the IRS notes that Willet left Betty a life estate in the income from the estate's assets, and that the interest paid on the delinquent tax payments was charged against income from the estate rather than estate principal. Finally, the IRS argues that the interest should not be allowed as a deductible administrative expense because it was paid after the estate had closed.

E. THE COURT'S HOLDING

The Court concludes that Plaintiffs are entitled to deduct from their gross estate the administrative expenses charged to income without a corresponding reduction in the marital deduction. These expenses, which were paid to accountants and to a mediator, were necessary to the proper administration of the estate, and the amount paid was reasonable. No

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[1] The IRS also contends that Plaintiffs have not offered sufficient evidence to prove that the expenses were actually incurred, but the Court considers this argument frivolous and worthy of no further discussion.

diminution in the marital deduction is required because the excess administrative expenses charged against income do not constitute a material limitation on Betty Brown's bequest.

To the extent administrative expenses were paid from marital bequest principal, the Court need not and will not engage in the fact-driven analysis regarding whether those expenses were reasonably and necessarily incurred. Even assuming those expenses were necessary and reasonable and therefore deductible, the Supreme court has clearly stated that charging administrative expenses against marital bequest principal reduces the value of the property passing to the surviving spouse and thus, results in a commensurate reduction in the marital deduction. Accordingly, to the extent those administrative expenses are deductible, this would have no effect on the tax liability of the estate given the effect on the marital deduction.

Finally, the Court concludes that the interest Plaintiffs paid to the IRS and the State of California constitutes a deductible administrative expense without a corresponding reduction in the marital deduction, pursuant to Revenue Rulings published by the IRS.

II.
FINDINGS OF FACT

A. THE PARTIES

Willet H. Brown and Betty Rhodes Brown married in 1948. Their marriage endured, he prospered, and in 1993, he died leaving an estate worth approximately $180 million dollars, which was his separate property under a pre-nuptial agreement that he and Betty negotiated prior to their marriage. Upon Willet's death, Betty, their attorney Raymond

Sandler ("Sandler"), Willet's son Michael, Willet's former secretary Beryl Rae, and Willet's long-time business associate Philip Melrose were named as co-executors of the estate, and as co-trustees of the marital trust, which was created under Willet's Last Will and Testament. (*See* Sandler Dec. ¶ 4; Plaintiffs' Ex. 24, at 2). They served as trustees of the marital trust commencing in December 1994, and served as Co-Executors of the estate from his 1993 death until the completion of probate on September 26, 1997.

B. THE WILL AND ESTATE

Under the terms of the will and various trust instruments, Willet named Betty the sole income beneficiary of two trusts: (1) the Willet H. Brown 1992 Marital Trust, which was the sole beneficiary in the Last Will and Testament of Willet H. Brown; and, (2) the Willet H. Brown 1993 Real Property Trust, the assets of which were included in the marital deduction as QTIP trusts. Among the assets in Willet's estate were the following: four closely held corporations, eleven radio stations, a collection of residential and commercial properties, a trove of personal property, a fleet of automobiles, stocks, bonds, cash, and a 83-foot yacht named "Invader." (*See* Sandler Dec. ¶ 31). All of these assets were included in the marital deduction. The remaining dispute between the IRS and the estate involves the deductibility of the expenses incurred in the administration of this estate.

C. THE ESTATE TAX RETURN

1. Computation of the Estate Tax

On January 13, 1995, in their capacity as Co-Executors of the Estate of Willet H. Brown, Plaintiffs filed a U.S. Estate Tax Return (Form 706) with the IRS, which reported a gross

estate of $181,801,820 and no estate taxes as due and/or payable. (*Id.* ¶ 11). Plaintiffs premised the computation of the estate taxes on their claim that, under Willet Brown's Will, the entire net estate qualified for the marital deduction under the provisions of 26 U.S.C. § 2056 of the Internal Revenue Code. (*Id.*)

2. Estimated Administrative Expenses

In the estate tax return, the Co-Executors estimated that the estate would ultimately incur $1,880,000 in administrative fees. Plaintiffs estimated that these fees would be spent as follows:

Legal Fees: $970,000
Accounting Fees: $45,000
Executors' Fees: $865,000

(*See* Sandler Dec. ¶ 14; Bieber Dec. ¶ 3). It is the difference between these estimates and the actual expenses incurred that is, in large part, responsible for the current dispute.

D. ADMINISTRATIVE EXPENSES

The estate actually incurred administrative expenses which greatly exceeded the estimates in each category included in the Form 706.

1. Legal Fees

During the course of the administration of the estate, several attorneys and firms were involved in a variety of legal matters. Sandler and Rosen represented Michael J. Brown, Philip A. Melrose, Beryl Rae and Raymond C. Sandler as co-executors, and Carol Perrin and Daphne Stegman represented Betty Brown as a co-executor. The legal fees incurred by the estate fall into two categories: statutory legal fees and

extraordinary legal fees.

a. *Statutory Legal Fees*

State law presumes that legal fees will be incurred in the normal administration of a decedent's estate, and provides for the payment of these fees as a percentage of the gross estate. *See* Cal. Prob. Code §10810 ("Compensation for conducting ordinary proceedings"). On motion by the Co-Executors, the probate court allowed the payment of $1,350,655 statutory legal fees under Section 10810. (*See* Supplemental Declaration of Charles L. Birke, ("Birke Dec.") Ex. 264). As permitted by California law (*see* Cal. Prob. Code § 10814), the attorneys agreed, based upon the relative legal work performed by each, that Sandler & Rosen was entitled to 77.225% of the attorneys' fees, or $975,510; Carol Perrin was entitled to 24.075% of the attorneys' fees, or $325,170; and Daphne Stegman was entitled to 3.7% of the attorneys' fees, or $49,975. (*Id.*)

b. *Extraordinary Legal Fees*

During the administration of the estate, a number of legal disputes arose which required the participation of counsel, whose fees were submitted to the probate court for payment as extraordinary legal fees. The major disputes include the following:

i. $5,500 payment for Mediator in connection with amortization of bond premium disagreement.

A disagreement arose regarding the proper treatment of amortization of bond premiums and deferred income. (*See* Sandler Dec. ¶ 15). This dispute affected distributions to the

income beneficiary and the Marital Trust. Judge Lopez of the Los Angeles County Superior Court directed the Co-Executors to retain a referee to make a recommendation to the court. (*Id.*) Thereafter, the Co-Executors spent $5,500 to hire retired California Supreme Court Justice Eagleson to mediate the dispute. (*Id.*; Plaintiffs' Ex. 218.)

ii. $96,788.75 in legal fees to Sandler & Rosen (*id.* at Exs. 250, 257), and $91,382.50 in legal fees to Carol Perrin (*Id.* at Exs. 252, 258) regarding accounting principles.

In a related matter, the estate paid substantial legal fees to resolve a dispute regarding proper accounting principles. Betty Brown asserted that California's Revised Uniform Principal and Income Act (Cal. Prob. Code §§ 16300-16315) was applicable in determining the computation of income of the estate during the period of probate administration. (*See* Ex. 250). Sandler believed that the application of the Uniform Principal and Income Act would benefit Betty Brown as the income beneficiary, at the expense of the Trust remaindermen. (*Id.*)

iii. $35,738.55 in legal fees to Sandler & Rosen (*id.*), and $53,142.50 in legal fees to Carol Perrin in connection with the "Invader" dispute. (*Id.* at Ex. 252).

During the administration of the estate, a question arose regarding whether the 83-foot yacht named "Invader" was a personal effect to be distributed to Betty Brown under the Will, or was property to be distributed to the Marital Trust. (*Id.*) After considerable discussion and an exchange of authorities between Betty Brown's attorneys and Sandler & Rosen, the parties decided that a Petition for Instructions

should be filed with the Probate Court, in hopes that the court would determine the validity of Betty Brown's claim that the "Invader" was either a motor vehicle or a "personal effect" which would be left to her free of trust. The court ultimately determined that the Invader was not a personal effect but rather, an asset, and that the Invader proceeds were to be treated as principal of the Marital Trust when distributed. (*Id.*)

iv. Payment of $10,455 in legal fees to Sandler & Rosen (*see id.* at Exs. 257, 261), and $9,145 in legal fees to Carol Perrin in connection with the gift tax dispute. (*Id.* at Exs. 252, 258).

As referenced above, the Internal Revenue Agent who reviewed the Form 706 Estate Tax Return, asserted that the Co-Executors failed to include in the return gift taxes in the amount of $1,415,732. (*See* Sandler Dec. ¶ 32). The estate incurred total legal fees of nearly $20,000 in response to this matter.

v. Payment of legal fees in connection with the sale of assets..

Additionally, the estate paid a substantial amount in extraordinary legal fees to the lawyers for their efforts in selling certain estate assets. During the administration of the estate, the lawyers participated in selling, *inter alia*, the yacht "Invader," the automobile collection, the radio stations, an Alfa Romeo Engine, a Beach Club Membership, the Coronado Condominium, the Canoga Park Condominium, the Venice Boulevard Property, the Hayden Property, and the Hermosa Beach Lots. (*Id.* at Exs. 250, 252).

Statutory Co-Executors' Fees

The estate paid $1,350,654 in statutory co-executor fees. (*See* Plaintiffs' Ex. 218). The four Co-Executors who received statutory executor fees agreed that the statutory compensation allowed by the Court would be equally divided among the four. Sandler, who was compensated via legal fees, did not receive statutory co-executor fees. Thus, each of the remaining Co-Executors received a fee of $337,663.50 for their performance of services as executors of the estate.

2. Accounting Fees

The estate ultimately paid $200,897.63 in accounting fees, which was $155,897.63 over and above the accounting fees estimated on the Form 706. These fees were paid to Schwartz Kales Accountancy Corporation and Ray, Hoover & Associates.

Schwartz Kales prepared the Form 706, which was derived from voluminous business and financial records maintained by the estate, including bank statements, brokerage statements, creditors' statements, financial statements, and the like. (*See* Beiber Dec. ¶ 2). The Schwartz Kales invoice (included as Plaintiffs' Ex. 244) was based upon actual work performed, and the costs incurred, at the regular rate charged by Schwartz Kales for the personnel involved. (*Id.* ¶ 20). These rates were commensurate with the rates of certified public accounting firms in the Los Angeles area. (*Id.*)

In approximately May of 1996, Ray, Hoover & Associates took responsibility for maintaining the books and records of Willet's estate. Betty Hoover testified that she personally supervised and actively participated in the preparation of the Estate of Willet H. Brown Summary of Account and

Supporting Schedules for the Period of October 14, 1993 through May 31, 1997, the Supplement to First and Final Account for the Period June 1997 through August 31, 1997, and the Second Supplement to the First and Final Account for the Period September 1, 1997 through September 22, 1997. (*See* Hoover Dec. ¶ 5). The rates Hoover & Associates charged for such services are as follows: $225.00 per hour for Betty Hoover and her Associate Partner; $125.00 per hour for the services of the CPA; $75.00 per hour for the services of para-professionals; and $40.00 per hour for the services of bookkeepers. (*See* Birke Supp. Dec. Ex. 264). These rates were commensurate with prevailing rates charged by certified public accounting firms in the Los Angeles area. (*See* Hoover Dec. ¶ 6).

E. Comparison of Estimated and Actual Administrative Expenses

The following table sets forth a comparison of the estimated administrative expenses and actual administrative expenses of the Willet Brown estate.

Category	Estimated	Actual	Difference
Executor's Fees	$865,000	$1,350,654	$485,654
Accounting Fees	$45,000	$200,897.63	$155,897.63
Statutory Legal Fees	$970,000	$1,350,655	$380,655
Extraordinary Legal Fees	$0	$689,817.40	$689,817.40
TOTAL	$1,880,000	$3,592,024.03	$1,712,024.03

Because the actual administrative expenses were unknown when the Form 706 was filed, no part of the $1,712,024.03 in excess actual administrative expenses was taken as a deduction or identified as an expense on any income tax return. (*See* Hoover Dec. ¶¶ 11, 16). Of the $1,712,024.03 in excess administrative expenses, the estate allocated $67,246.84 against estate income and $1,644,777.19 against estate principal. (*See* Bieber Dec. ¶ 10). Moreover, of the $67,246.84 charged against marital bequest income, $64,496.84 constitutes payments to the accountants, and $2,750 constitutes one-half of Justice Eagleson's mediator fee. (*See* Beiber Dec. ¶ 10; Plaintiffs' Ex. 223).

B. PROBATE COURT APPROVAL

All of the statutory legal and executors' fees, and all of the extraordinary legal fees paid by the estate were expressly approved by orders of the Los Angeles County Superior Court, sitting in probate, based upon factual evidence submitted in applications for such approvals. The extraordinary legal fees paid by the estate were awarded by the Los Angeles County Superior Court by orders of November 4, 1996, November 8, 1996, July 21, 1997, and July 21, 1997, based upon petitions filed September 6, 1996, October 8, 1996, June 5, 1997 and June 12, 1997. (*Id.* ¶ 27; *see* Birke Supp. Dec., Exs. 254, 255, 262, 263).

On July 31, 1997, Plaintiffs filed the Verified First and Final Account and Report of Co-Executors and Petition for Allowance of Compensation for Ordinary Service to Co-Executors and Their Attorneys, for Reimbursement of Expenses Incurred by the Co-Executors' Attorneys, and for Final Distribution. (*Id.* at Ex. 264). The Verified First and Final Account sets forth facts supporting the application for executors' fees, attorneys' fees and costs. (*Id.*)

On September 26, 1997, the Los Angeles County Superior Court entered its Order Settling the First and Final Account and Report of Co-Executors Allowing Compensation for Ordinary Service to Co-Executors and Their Attorneys and Reimbursement of Expenses Incurred by the Co-Executors' Attorney and for Final Distribution. (*Id.* at Ex. 265). The court found at page 2:

> 1. Notice of hearing of the petition has been regularly given as prescribed by law.
>
> 2. All acts and transactions of the Co-Executors of the Estate of Willet H. Brown, Deceased, during the period of the account, are truly shown and should be approved.
>
> 3. All allegations of petition for a settlement and for final distribution are true.

The court ordered in paragraph 2, at page 4:

> 2. As of May 31, 1997, the Co-Executors had in their possession belonging to the estate, after deducting credits to which they are entitled, a balance at the book value of $236,581,101.58, of which $7,488,091.17 was in cash, and of which $3,831,208.19 represented undistributed income. The First and Final Account and Report and Petition of the Co-Executors is settled, allowed, and approved as filed.

The court ordered in paragraph 3, at page 5:

> 3. The Co-Executors are authorized and directed to pay to each of the Co-Executors except RAYMOND C. SANDLER the sum of $337,663.50 as statutory compensation for services rendered in administering this estate, and to pay to SANDLER AND ROSEN the sum of $975,510, to DAPHNE STEGMAN, ESQ. the sum of $49,975, and to CAROL PERRIN, ESQ. the sum of $325,170 as statutory compensation for services rendered in the administration of the estate, and to SANDLER AND ROSEN the sum of $17,942.57 and to CAROL PERRIN, ESQ. the sum of $4,291.13 as reimbursement for costs and expenses incurred by them in the performance of their services in administering this estate.

All of the accounting fees listed on Exhibit B to the Complaint (Plaintiffs' Ex. 218) were included in the First and Final Account filed with and approved by the Probate Court, except for $61,606.68 in accounting invoices rendered after the First and Final Account had been filed with the court. (*See* Birke Dec. Ex. 264; Sandler Dec. ¶ 29).

G. NOTICE OF DEFICIENCY

While state probate proceedings were wrapping up in late 1997, the estate was on the verge of litigation with the IRS. On January 5, 1998, the IRS sent the Co-Executors a Notice of Deficiency (90-day letter) asserting a deficiency in the federal estate taxes of $1,663,650 less credits of $188,986 for state death taxes paid by the estate, for a net tax due and owing of $1,474,664. Among other things, the IRS contended that gift taxes in the amount of $1,415,732 paid by Betty Brown on April 15, 1993 were actually paid by Willet

Brown, and should have been included under Schedule G, Form 706 as a transfer during his life in accordance with provisions of § 2035(c) of the Internal Revenue Code. (*See* Order, at 9). On January 28, 1998, Plaintiffs responded to the notice by remitting the sum of $2,096,107 (the principal amount of the tax due – $1,474,664 plus accrued interest of $621,443) to the IRS. On July 13, 1998, after having concluded that the estate overpaid the amount of interest due on the federal estate tax deficiency, the IRS sent Plaintiffs a refund in the amount of $71,593.11, leaving a balance of $1,474,664 principal and $549,850 in interest, for a total of $2,024,514 paid by the estate to the IRS. (*Id.*; Sandler Dec. ¶ 33).

Plaintiffs charged the tax payments against estate principal, and the interest payments against estate income. (*See* Bieber Dec. ¶ 14). Moreover, the estate also paid interest in the amount of $80,400 to the Treasurer of the State of California, which was also charged against estate income (*id.*), pursuant to the California Principal and Income Act. (*Id.* ¶ 15; Sandler Dec. ¶ 35). None of the interest paid to the IRS or the State Treasurer was deducted on any income tax return of Betty Brown, the Estate of Willet H. Brown, or the Marital Trust created under the Will of Willet H. Brown. (*See* Hoover Dec. ¶ 16).

H. PLAINTIFFS' CLAIM FOR REIMBURSEMENT

On October 13, 1998, Plaintiffs filed a Form 843 "Claim for Refund and Request for Abatement" with Defendant. (*See* Order at 9). Plaintiffs claimed a refund in the amount of $2,024,514, being the total amount of federal estate taxes and interest paid by Plaintiffs, and demanded refund and repayment of that sum together with interest as provided by law. (*Id.* at 9-10). After more than six months had elapsed

from the time Plaintiffs filed their claim for refund, Plaintiffs had received no response from Defendant. (*Id.* at 10).

I. PLAINTIFFS' COMPLAINT

Following Defendant's failure to respond to Plaintiffs' claim for reimbursement, Plaintiffs filed the present Complaint for Recovery of Federal Estate Taxes and Interest Erroneously and Illegally Collected. (*Id.*) The First Claim for Relief was summarily adjudicated in favor of the IRS. The Second and Third Claims were tried to the Court this past June.

The Second Claim for Relief asserts that, notwithstanding the Court's holding on Plaintiffs' first cause of action, the estate owes no tax liability because the taxable estate should be reduced by the amount of administrative expenses actually incurred in excess of the expenses estimated in the estate tax return. As noted above, the actual expenses exceeded the estimated expenses by $1,712,024.03, which is greater than the amount of $1,415,732 claimed by the IRS as improperly excluded from the taxable estate. (*Id.* ¶ 22). Plaintiffs allege that the $1,712,024.03 in additional administrative expenses not claimed as a deduction on the Federal Estate Return should be allowed as an offset to the deficiency claimed by the IRS, but without reducing the marital deduction. (*Id.* ¶ 23). Thus, Plaintiffs assert that no tax should have been assessed against the estate.

The Third Claim for Relief asserts that the taxable estate should be reduced by the amount of interest on the delinquent taxes paid by the estate in 1998. Again, Plaintiffs claim that the deduction should be allowed without a corresponding

reduction of the marital deduction per Revenue Ruling 93-48.[2] (*Id.* ¶ 45).

CONCLUSIONS OF LAW

A. BURDEN OF PROOF

Because Plaintiffs claim the right to deduct from Willet Brown's taxable estate certain administrative expenses and interest payments, they bear the burden of substantiating these deductions. *See, Gatto v. Commissioner*, 1 F.3d 826, 828 (9th Cir. 1993); *Foster v. Commissioner*, 756 F.2d 1430, 1439 (9th Cir. 1985); *Amey & Monge Inc. v. Commissioner*, 808 F.2d 758, 761 (11th Cir. 1987) ("Because the taxpayer is privy to the facts that substantiate a deduction, he must bear the burden of proving his right to, and amount of, a claimed deduction."); *International Trading Co. v. Commissioner*, 275 F.2d 578, 584 (7th Cir. 1960) ("All deductions, whether with respect to individuals, or corporations, are a matter of legislative grace, and unless the claimed deductions come clearly within the scope of the statute, they are not to be allowed .... The burden to make that showing rests upon the taxpayer.").

B. THE EFFECT OF THE ADMINISTRATIVE EXPENSES ON THE MARITAL DEDUCTION

Even assuming that the excess administrative expenses were reasonable, and actually and necessarily incurred, as

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[2] The parties agree that, if the interest can be deducted, a series of computations will need to be made to determine the amount of refund owed. Defendant has stipulated that if the Court finds for Plaintiffs on the Third Claim for Relief, Defendant will calculate the amount of overpayment and refund due to Plaintiffs.

required under 26 C.F.R. § 20.2053-3, the IRS argues that allowing the deduction of the excess administrative expenses incurred by Willet's estate would have no effect on the estate's tax liability because the reduction in the taxable estate would be offset by a corresponding reduction in the marital deduction. In support of this contention, the IRS presents two arguments.

First, the IRS notes that the estate charged a substantial portion of the excess administrative expenses against estate principal. According to the IRS, recent Supreme Court precedent teaches that when administrative expenses are charged against marital bequest principal, the estate must *always* make a dollar-for-dollar reduction in the marital deduction. (*See* United States' Amended Memo. of Contentions of Fact and Law, at 19). Second, the IRS argues that the excess administrative expenses which the estate charged to income constitute a "material limitation" on Betty's right to receive income from the marital bequest and thus reduce the value of that bequest. (*Id.* at 21). For that reason, the IRS again claims that the marital deduction must be reduced by an amount equivalent to the reduction in the value of the bequest.

Because resolution of these legal issues may eliminate the need to engage in the fact-intensive inquiry regarding the necessity and reasonableness of the administrative expenses at issue, the Court addresses them first.

1. The Marital Deduction

The marital deduction allows an estate to deduct, for federal estate tax purposes, "an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that

such interest is included in determining the value of the gross estate." 26 U.S.C. § 2056(a). "The statute allows deduction for qualifying property only to the extent of the property's 'value.'" *Commissioner v. Estate of Hubert*, 520 U.S. 93, 100 (1997). In other words, any interest in property that is both included in valuing the estate and left to the surviving spouse may be deducted from the gross estate in computing estate taxes. According to the regulations in force at the time of Willet's death, "account must be taken of any material limitations upon her right to income from the property" in valuing the bequest to the surviving spouse. Treas. Reg. § 20.2056(b)-4(a).

2. The Marital Deduction Must be Reduced by the Amount of Administrative Expenses Charged Against Estate Principal

Whether and to what extent a spouse takes property subject to a material limitation raises complex estate tax issues. In this case, the Court must address the extent to which the payment of administrative fees from estate principal and/or income constitutes such a limitation. The Court commences the analysis with the most recent Supreme Court case on the issue.

a. Estate of Hubert

In *Estate of Hubert*, the surviving spouse received a bequest, including gifts in trust and certain income interests, that the parties agreed was the equivalent of a transfer of a fee interest in property. *See, Estate of Hubert*, 520 U.S. at 107. The parties further agreed that: (1) the interests transferred in trust to the surviving spouse qualified for the marital deduction; and (2) the allocation of administrative expenses to estate principal, which reduced the value of the estate to the

surviving spouse, warranted a dollar-for-dollar reduction in the marital deduction. *Id.* at 99. On the latter point, Justice Kennedy noted:

> The estate recalculated its estate tax liability based on the settlement agreement and the payments from principal. The estate did not include in its marital and charitable deductions the amount of residue principal used to pay administration expenses. The parties here have agreed throughout that the marital or charitable deductions could not include those amounts.

520 U.S. at 98-99.

All nine Justices appear to concur on that point. Justice O'Connor, writing for the three judges who concurred in the plurality's result, though not its reasoning, stated:

> Everyone agrees that when these expenses are charged against a portion of the estate's principal devised to the spouse or charity, that portion of the principal is diverted from the spouse or charity and the marital and charitable deductions are accordingly "reduced" by the actual amount of expenses incurred. The question presented here is what becomes of these deductions when the estate chooses the second option under § 642(g) and allocates administrative expenses to the postmortem income generated by the property in the spousal or charitable devise.

Id. at 112-13 (internal citations omitted). Justice Scalia made

the same point in dissent:

> [A]s the plurality correctly recognizes, and as both parties agree, if any portion of marital bequest principal is used to pay estate administrative expenses, then the marital deduction must be reduced commensurately.

Id. at 123.

Even though the Justices in *Estate of Hubert* appear unanimous on this issue, Plaintiffs cite the case to support their claim that the marital deduction need not be reduced by the allocation of administrative expenses to principal.

b. Plaintiffs' Misplaced Reliance on Hubert

Plaintiffs find solace in *Hubert* only by ignoring the single issue on which the nine Justices agreed. Turning a blind eye to the unequivocal observations made in the plurality, the concurrence and Justice Scalia's dissent, Plaintiffs argue that in *Estate of Hubert*, "the sole question decided was whether *administrative expenses charged to income* necessarily reduced the marital deduction on a dollar-for-dollar basis" and that the effect of charging administrative expenses to principal was not before the Court. (*See* Plaintiffs' Reply to United States' Amended Memo. of Contentions of Fact and Law, at 9) (emphasis in original). Although literally accurate, Plaintiffs' claim that *Estate of Hubert* discussed only in *dicta* the effect of allocating administrative expenses to estate principal is the beginning, not the end, of the discussion.

Courts frequently discuss undisputed matters that bear some relationship to the issue at hand as a means of placing the issue in proper context. Specifically, courts will often

compare the facts presented in a pending case, where the parties disagree as to the state of the law, with a readily distinguishable set of facts where no such disagreement exists, to define the issue and focus the discussion. Both Justices Kennedy and O'Connor employed that technique in their opinions, which were joined by five other Justices. For example, in the plurality opinion, Justice Kennedy wrote:

> The parties here agree that the marital and charitable deductions had to be reduced by the amount of marital and charitable residue principal used to pay administration expenses. The Commissioner contends that the estate must reduce its marital and charitable deductions by the amount of administration expenses paid not only from principal but also, and in all events, from income and by a dollar-for-dollar amount.

520 U.S. at 105.

Likewise, Justice O'Connor noted that "everyone agrees" that the marital deduction must be reduced by the amount of principal used to pay administrative expenses, and then observed:

> The estate, however, did not reduce its marital or charitable deductions by the amount of the *income* used to pay the balance of the administration expenses. The Commissioner disagreed and contended that use of income for this purpose required a dollar-for-dollar reduction of the amounts of the marital and charitable deductions.

Id. at 113 (emphasis added).

If the Supreme Court's remarks regarding the effect of allocating administrative expenses to estate principal were truly aberrational, the Court would have expected Plaintiffs to provide authority for the contrary proposition. Plaintiffs have failed to do so, and the reason has become apparent to the Court. Taken in context, the comments of the Supreme Court reveal a unanimity on a point that, in all likelihood, is obvious in view of the controlling statute. The beneficiary may take a marital deduction to the extent that property is included in valuing the estate. Reductions in estate principal reduce the value of the estate, which in turn requires an equivalent reduction in the marital deduction. Thus, to ignore the uniform comments of the three opinions as *dicta* is to ignore the command of the very statute that created the marital deduction in the first place.

Nonetheless, Plaintiffs propose another approach to distinguishing *Estate of Hubert* from the present case. (*See* Proposed Findings of Fact and Conclusions of Law, at 15). According to Plaintiffs, Betty Brown, as the income beneficiary of QTIP trusts actually benefitted from the fact that the estate charged $1,644,777.19 to principal rather than income.[3]

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[3] Defendant contends that this argument is barred by the doctrine of variance because it was not specifically set forth in the claim for refund. (*See* United States' Proposed Findings of Fact, at 22). It is not. The "substantial variance" rule is based on 26 U.S.C. § 7422(a), and requires a refund claim to be 'duly filed' with the Internal Revenue Service before a taxpayer may maintain a lawsuit for a tax refund. *See, Cook v. United States*, 599 F.2d 400, 406 (Cl.Ct. 1979). The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprize the Commissioner of the exact basis thereof. *See* 26 C.F.R. § 301.6402-2(b)(1) (1971). In this case, the "economic benefit argument" is Plaintiffs' attempt to prevent a reduction of the marital

(*Id.* at 15-16). This conclusion is based upon Plaintiffs' observation that, had this amount been charged to income, Betty Brown, as the income beneficiary, would have suffered a dollar-for-dollar reduction of money paid to her. (*Id.* at 16). However, as this argument is based upon a faulty understanding of the *Estate of Hubert* opinion, the Court is unpersuaded.

As set forth above, the marital property in this case is comprised of a QTIP trust. While Betty Brown is only the income beneficiary of this Trust, the marital property passing to Betty was *valued* as being equivalent to a transfer in fee, with the corpus of the Trust included in Betty's bequest. It would be inconsistent, on one hand, to allow Plaintiffs to enjoy the benefits of avoiding estate taxation by essentially treating Betty's bequest as a transfer in fee, but on the other, avoid reducing the marital deduction by treating the bequest as an interest in Trust income only.

The Court's analysis adheres to the reasoning of the Supreme Court in *Estate of Hubert*. As noted above, the marital property in *Estate of Hubert* also consisted of trusts, which included both a general power of appointment trust, and a QTIP trust. *See, Estate of Hubert*, 520 U.S. at 107. Although there is no discussion in *Estate of Hubert* regarding whether the surviving spouse was the income or principal beneficiary of these trusts, the Supreme Court observed that the marital property was "valued as being equivalent to a transfer of the fee," and was treated as such by the Court. *Id.*

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deduction in the amount of the administrative expenses incurred by the estate, an argument that appeared in Plaintiffs' Claim for Refund and Request for Abatement. (*See* Plaintiffs' Ex. 17, at 8). Moreover, the "economic benefit argument" is based, in part, upon *Estate of Hubert*, which Plaintiffs cited in the Claim for Refund. Thus, Plaintiffs' "economic benefit" argument does not vary substantially from the assertions contained in the Claim for Refund.

This Court will not deviate from what Justice O'Connor has dubbed the "accepted rule" based on Betty's interest as an income beneficiary since the property transferred has already been valued as a transfer in fee.

Finally, Plaintiffs argue that not reducing the marital deduction would advance the policies of Congress in enacting marital deduction legislation, where the spouse is only an income beneficiary. (*See* Plaintiffs' Reply to United States Amended Memo. of Contentions of Fact and Law, at 9). For obvious reasons, however, the Court is loath to deviate from the clear instructions of at least five (if not all nine) Justices of the Supreme Court on the basis of Plaintiffs' unsupported inference regarding Congressional intent. In any event, Supreme Court precedent also teaches that resort to legislative intent is proper only where the statutory command is vague or ambiguous. *See, e.g., Ex parte Collett*, 337 U.S. 55, 61 (1949). This is not such a case. Thus, to the extent the administrative expenses are deductible, any expenses charged against principal must result in a corresponding reduction in the marital deduction.

3. The Marital Deduction is Not Reduced by the Amount Charged to Income

The IRS argues that the marital deduction claimed by the estate must be reduced by the amount of the administrative expenses charged against income, as that amount constitutes a "material limitation" on Betty Brown's right to income. (*See* United States' Proposed Findings of Fact and Conclusions of Law, at ¶ 32). For the reasons that follow, the Court disagrees.

As noted above, the Supreme Court recently addressed whether administrative expenses paid from income generated

by assets allocated to the surviving spouse reduce the martial deduction. *See, Estate of Hubert*, 520 U.S. at 111. Although seven Justices concurred that the marital deduction should not be reduced under the facts of the case, no five were able to agree on a single opinion. Both the plurality opinion and the concurrence turned on the meaning of the same word – "material" – as used in section 20.2056(b)-4(a).

According to Justice Kennedy, the materiality of a limitation on a surviving spouse's right to income is determined by deciding whether the date-of-death value of the expected future administrative expenses is material in comparison with the date-of-death value of the expected future income. *See, Estate of Hubert*, 520 U.S. at 109-10. Under this theory, since value is determined as of the date of death, it is the executor's anticipated use of income for administrative expenses as opposed to actual administrative expenses, that must be evaluated. *Id., See also,* Bittker & Lokken, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 129.5.3 (2001 Supp.).

In contrast, Justice O'Connor held that the value of the marital deduction should be evaluated on the basis of "quantitative materiality." *Id.* at 119-20 (O'Connor, J., Concurring). Specifically, Justice O'Connor opined that "a limitation affects the marital deduction only upon reaching a certain quantum of substantiality." *Id.* Two factors present in the case, however, prevented Justice O'Connor from clearly articulating how this test should be applied. First, in arguing the case, the Commissioner in *Estate of Hubert* asserted that *any* limitation, regardless of quantum, must be reflected in the estate tax evaluation. *Id.* at 119. Thus, the Supreme Court found no basis for reviewing the tax court's conclusion that a $1.5 million administrative expense was not a "material limitation" on the surviving spouse's bequest. Moreover,

Justice O'Connor ultimately avoided having to apply the quantitative materiality test by analogizing to Revenue Ruling 93-48.[4] *Id.* at 118 (citing Rev. Rul. 93-48).

Nevertheless, the Court finds that Justice O'Connor's quantitative materiality test provides the simplest means of addressing the questions before this Court. In her concurring opinion, Justice O'Connor indicated that administrative expenses totaling 5% of the estate would constitute a material limitation upon the surviving spouse's right to income. *See, Estate of Hubert*, 520 U.S. at 121 (O'Connor, J., Concurring). In stark contrast, the $67,246 Plaintiffs charged to income in this case constitutes roughly .04% of the estate, and .3% of the $20,002,644 in income actually distributed to Betty Brown during the pendency of the estate alone. (*See* Bieber Dec. ¶ 11). This percentage is further diminished when one considers that at the time the estate closed, it had increased in value some $80 million, (*see* Sandler Dec. ¶ 16), and that its anticipated income stream, even reduced to present value, was enormous. Thus, the excess administrative expenses actually incurred in this case fall far short of the "quantum" of materiality envisioned by Justice O'Connor.

In sum, to the extent the excess administrative expenses are deductible under federal law, expenses charged against principal result in a corresponding reduction in the marital deduction. Deductible administrative expenses charged against income do not, so long as they do not constitute a material limitation on the surviving spouse's right to income from the property. In this case, the excess administrative expenses

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[4] Revenue Ruling 93-48 provides, *inter alia*, that the marital deduction is not ordinarily reduced when an executor allocates interest payments on deferred federal estate taxes to the postmortem income of the spousal bequest.

charged against income do not constitute a material limitation on Betty Brown's right to income from the property.

C. Necessity and Reasonableness of the Excess Administrative Expenses Charged to Income

Because administrative expenses charged to principal result in a dollar-for-dollar reduction in the marital deduction, the Court need not address the necessity or reasonableness of any such expenses. However, since the Court has concluded that the administrative expenses charged against income did not constitute a material limitation on Betty's bequest, they may be deducted without any diminution in the marital deduction, if they otherwise qualify under federal law. The Court therefore addresses whether those administrative expenses are properly deductible under federal law.

Federal tax law provides that the value of the taxable estate is to be determined by deducting "administrative expenses" from the value of the gross estate, to the extent such expenses are allowable under governing state law. *See* 26 U.S.C. § 2053. Administrative expenses include: (1) executors' commissions; (2) attorneys' fees; and (3) miscellaneous expenses. 26 C.F.R. § 20.2053-3. These expenses may include only those expenses *actually* and *necessarily* incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. *Id.* Moreover, even if an expense is actually and necessarily incurred in the administration of the estate, it must also be "reasonable under the circumstances." *See, Pitner v. United States*, 388 F.2d 651, 659 (5th Cir. 1967).

In this case, there is no reasonable dispute that the estate actually incurred the administrative expenses that are in

dispute. Moreover, the Court previously ruled that, since the Probate Court already determined that the administrative expenses were allowable under state law, the Court would not revisit that issue. (*See* May 17, 2001, Minute Order at 1) (citing 26 C.F.R. § 20.2053-1). As noted above, however, such a determination marks only the beginning of the deductibility inquiry. *See, Hibernia Bank v. United States*, 581 F.2d 741, 743 (9th Cir. 1978). Federal law determines whether the expenses were necessary to the administration of the estate, and reasonable in amount, and therefore whether they may be deducted from a decedent's estate. *Pitner*, 388 F.2d at 659.

In this case, the estate charged $67,246.84 in excess administrative expenses against marital bequest income. Of this amount, $64,496.84 constitutes accountants' fees, and $2,750 constitutes one-half of the referee fee paid to Justice Eagleson. (*See* Bieber Dec. ¶ 10; Plaintiffs' Ex. 223). For the reasons that follow, the Court finds that both are properly deductible pursuant to section 2053.

1. Accountants' Fees

Accountants' fees necessarily incurred in preserving and distributing an estate are deductible as miscellaneous administration expenses. *See* 26 C.F.R. § 20.2053-3(d)(1). In this case, the estate paid a total of $200,897.63 in accounting fees, (*see* Plaintiffs' Ex. 218), of which $64,496.84 was charged against postmortem marital bequest income. (*See* Plaintiffs' Ex. 223).

a. Necessity of the Accountants' Fees

Two accountancy firms performed most of the accounting work for the estate: Schwartz Kales and Ray, Hoover &

Associates. As discussed above, Schwartz Kales prepared the Form 706, and participated in the resolution of various accounting issues that arose during the course of the administration of the estate. Ray, Hoover & Associates prepared various summaries of accounts and supporting schedules. Given the magnitude of the estate and the complexity of the accounting and allocation issues involved in the administration, the Court concludes that the services of the accounting firms were necessary to properly preserve and distribute the estate.

b. Reasonableness of the Rates Charged

Both Schwartz Kales' and Ray, Hoover & Associates' fees were based upon actual work performed, and the costs incurred, at the regular rate charged by both firms. (*See* Plaintiffs' Ex. 244; Hoover Dec. ¶ 6). Moreover, the rates charged by both are commensurate with the rates of certified public accounting firms in the Los Angeles area. (*See* Bieber Dec. ¶ 20; Hoover Dec. ¶ 6). Thus, the Court concludes that the accounting fees paid by the estate were reasonable.

2. Referee Fees Paid to Justice Eagleson

Referee fees constitute miscellaneous administration expenses, and are deductible only if they are necessarily incurred in preserving and distributing the estate. *See* 26 C.F.R. 20.2053-3(d)(1). In this case, the estate paid Justice Eagleson $5,500 in referee fees. (*See* Plaintiffs' Ex. 218). Of this amount, $2,750 was allocated to income. (*See* Bieber Dec. ¶ 10; Plaintiffs' Ex. 223).

a. Necessity of the Referee Fee Paid to Justice Eagleson

During the administration of the estate, a disagreement arose regarding the proper treatment of amortization of bond premiums and deferred income. (*See* Sandler Dec. ¶ 15). This dispute affected distributions to the income beneficiary and the Marital Trust. Given the complexity of the issue, Judge Lopez of the Los Angeles County Superior Court directed the Co-Executors to retain a referee to make a recommendation to the court. (*Id.*) Thereafter, the Co-Executors hired Justice Eagleson to resolve the disagreement. Because proper resolution of this issue affected distribution of estate assets, the Court concludes that the referee's fees incurred were necessary for purposes of section 2053.

b. Reasonableness of Justice Eagleson's Referee Fee

Justice Eagleson presided over a hearing during which the attorneys presented evidence and legal arguments regarding the proper treatment of the amortized bond premiums. After the hearing, Justice Eagleson issued an order which was adopted in its entirety by the California Superior Court, sitting in probate. Given the complexity of the issue, the fact that Justice Eagleson was ultimately responsible for resolving the dispute, and given his experience as a former Justice of the California Supreme Court, the Court concludes that $5,500 is a reasonable amount for the referee fee.

3. Conclusion

Plaintiffs may deduct the $67,246.84 as administrative expenses pursuant to section 2053, without a corresponding deduction in the marital deduction. The services provided by

the accountants and Justice Eagleson were necessary to the proper administration of the estate. Given the rates charged, and the importance of the services provided, the fees paid were reasonable.

D. INTEREST

Plaintiffs argue that the $630,446 the estate paid in interest ($549,850 paid to the IRS, and $80,596 paid to the State of California), is allowable as an administrative expense deduction, without a corresponding reduction in the marital deduction, pursuant to Revenue Ruling 93-48. (*See* Plaintiffs' Memo. of Contentions of Fact and Law, at 13).

1. Interest is a Deductible Administrative Expense

In Revenue Ruling 79-252, the IRS clearly resolved any dispute surrounding whether interest on a federal estate tax deficiency is deductible for estate tax purposes under section 2053(a)(2). In that ruling, the IRS observed that section 2053 of the Code and the applicable regulations instruct that the value of the taxable estate is determined by deducting from the value of the gross estate amounts expended for necessary administrative expenses to the extent allowable by local law. In accordance with these provisions, the IRS determined that "post-death interest on an income tax deficiency is a necessary administrative expense and is deductible under section 2053(a)(2) of the Code to the extent allowable under local law." Rev. Rul. 79-252. To be clear, the Ruling continues by noting that "[f]or purposes of section 2053(a)(2), no distinction should be drawn between interest incurred on a gift tax deficiency [which is deductible], and interest incurred on an estate tax deficiency." *Id.* Thus, the interest which accrued on Plaintiffs' estate tax liability constitutes a deductible administrative expense. *See also* Revenue Ruling 81-154;

1990 WL 701268 (I.R.S. TAM Dec. 21, 1990).

2. The Effect on the Marital Deduction

The IRS argues that the interest paid by Plaintiffs reduces the marital deduction on a "dollar-for-dollar basis." (*See* United States' Amended Memo. of Contentions of Law, at 22). In support of this claim, the IRS raises three arguments. For the reasons set forth below, the Court finds none of them persuasive.

a. Applicability of Revenue Ruling 93-48

The IRS argues that Revenue Ruling 93-48 is inapplicable here because this case involves interest accruing on a notice of deficiency, and not "post-death interest accruing on deferred federal estate tax." (*See* United States' Amended Memo. of Contentions of Fact and Law, at 22).[5]

Revenue Ruling 93-48 provides: "[t]he Service has adopted the result of recent court decisions, which hold [sic] that post-death interest accruing on deferred federal estate tax payable from a testamentary transfer does not ordinarily reduce the date-of-death value of the transfer." Rev. Rule 93-48 (July 19, 1993). Notably, the last sentence of the Revenue Ruling provides: "Rev. Rul. 80-159 is clarified to hold that the value of the marital bequest for purposes of section

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[5] Defendant also argues that interest is deductible only as long as it does not result in a "double deduction." Pursuant to 26 U.S.C. § 642(g), an estate may take a tax deduction for administration expenses under section 2053(a)(2), or it may take them, if deductible, from its taxable income, but it may not do both. In this case, there is no evidence that Plaintiffs are seeking a double deduction. As set forth above, no interest paid to the IRS or the State Treasurer was deducted on any income tax return. (*See* Hoover Dec. ¶ 5).

2056(b)(4) is not reduced by post-death interest expense accruing on taxes even if state law requires payment from the marital bequest of estate tax and interest on the tax." Rev. Rul. 93-48. The phrase "post-death interest expense accruing on taxes" is not modified, nor is there any restrictive language suggesting that the ruling does not apply to interest accruing on taxes arising by way of deficiency notice.

Moreover, Revenue Ruling 93-48 cites *Estate of Richardson v. Commissioner*, 89 T.C. 1193 (1987). *See* Rev. Rul. 93-48 ("The Internal Revenue Service has reconsidered Rev. Rul. 82-6, 1982-1 C.B. 137, in view of recent court decisions in *Estate of Richardson v. Commissioner.*"). In *Estate of Richardson*, the tax court provided:

> The principal issue remaining for decision is whether interest payable by petitioners on federal estate taxes and state inheritance taxes, **and on deficiencies** with regard to such taxes, is chargeable against the principal of the estate or income produced by the principal. **If the interest is chargeable against income it will not reduce the value of the interest in the estate that passes to the surviving spouse under the will and consequently will not reduce the amount of the marital deduction.**

Id. At 1200 (emphasis added). The IRS promulgated Revenue Ruling 93-48, in part, to conform with the holding of *Estate of Richardson*. To adopt the IRS' position in this case, the Court would be forced to construe Revenue Ruling 93-48 in such a way to contradict the holding of the case after which the Ruling was modeled.

Perhaps even more telling, however, is the IRS' total failure to provide a shred of authority in support of the argument that Revenue Ruling 93-48 is inapplicable here. The IRS has not cited a single case, regulation, or statute to suggest that Revenue Ruling 93-48 does not apply to interest due by way of deficiency notice. As the IRS' unsupported argument is belied by the unequivocal language of the Ruling, and a tax court case upon which the Ruling was premised, the Court is unpersuaded by the IRS' argument.

b. Is There a Material Limitation Standard on Interest Payments Charged to Marital Bequest Income?

Defendant argues that the marital deduction must be reduced because the estate, by charging the interest to marital bequest income, materially limited Betty Brown's right to income from the property. (*See* United States' Amended Memo. of Contentions of Law, at 26) (citing *Estate of Hubert*, 520 U.S. at 26). In support of this argument, the IRS quotes extensively from the Supreme Court's opinion in *Estate of Hubert*. (*Id.* at 24-26).

As thoroughly discussed above, *Estate of Hubert* involved administrative expenses charged against marital bequest income. Under the facts of that case, the Supreme Court looked to Treasury Regulation 20.2056(b)-4(a) for guidance in ascertaining the value of the property passing to the surviving spouse. Unlike other administrative expenses, however, the IRS has specifically addressed the impact of interest payments on the value of the marital deduction in Revenue Ruling 93-48. Revenue Ruling 93-48 contains no "material limitation" standard. This lack of limiting language might be the result of an oversight, or, on the other hand, it might reflect that in the IRS' view, interest payments, by

definition, are immaterial. Notwithstanding its failure to include such a limitation in the Rule, the IRS now invites the Court to impose the material limitation language of Treasury Regulation 20.2056(b)-4(a) on Revenue Ruling 93-48. Because such an undertaking would require the Court to disregard the unqualified language of the Revenue Ruling, the Court declines this invitation. To the extent the IRS seeks to essentially promulgate a new rule, by imposing a material limitation standard where none existed previously, the proper method for doing so is not through the courts.

Finally, the Court concludes that even if a material limitation standard applied to interest payments, the payment of interest from marital bequest income in this case would not constitute a material limitation on Betty's right to income. Of course, applying Justice Kennedy's materiality test would be next to impossible, as it would require the Court to ascertain the date-of-death value of the expected interest due on a notice of deficiency. With respect to Justice O'Connor's "quantitative materiality" test, the $630,436 constitutes less that .4% of the income producing corpus, and approximately 3.1% of the $20,002,644 in income Betty received during the pendency of the estate alone. (*See* Bieber Dec. ¶ 11). Thus, given the size of the income producing corpus, the amount the estate paid in interest in this case falls short of the quantum of substantiality, assuming such a test even applied to interest payments.

c. Plaintiffs' Authority to Charge Interest to Post-Mortem Income

The IRS argues that the Co-Executors did not have the right to allocate administrative expenses (including interest on

the tax liability) to the marital bequest postmortem income.[6] (*See* United States' Amended Memo. of Contentions of Law, at 30). In support of this argument, Defendant cites the fifth paragraph of Willet H. Brown's Last Will and Testament, which provides:

> A. . . . I do hereby provide my Executor to pay out of the residue of my estate all federal estate taxes and state inheritance taxes resulting from or payable on account of or by reason of my death, whether or not attributable to properties subject to probate administration, and the beneficiaries under this Will shall not be charged with such taxes.

(*Id.*)(quoting Plaintiffs' Ex. 24, at 3-4).

This language does not mean what the IRS claims it does, and must be read in light of the remainder of the Will. For example, Paragraph E of the Eighth Article provides:

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[6] As an initial matter, Defendant's argument that the Co-Executors lacked the authority to charge the accrued interest against income is not included as a defense in the Pretrial Order. As such, this argument is procedurally barred. Moreover, the relevance of this argument is lost on the Court. At least five members of the Supreme Court have explicitly recognized that Revenue Ruling 93-48 applies where interest is charged to principal or income. *See, e.g., Estate of Hubert*, 520 U.S. at 119 (O'Connor, J., Concurring) ("[T]he ruling purports to apply not only to income but also to principal"). *See also id.* at 130 (Scalia, J., Dissenting) ("Revenue Ruling 93-48 is not limited to payment from marital bequest *income*, but rather extends to payment from marital bequest *principal* as well."). Thus, even if Plaintiffs had charged the interest against principal, this would ultimately have no effect on the value of the marital deduction.

> All taxes, assessments, fees, charges and other expenses incurred by the Trustees in the administration or protection of the trust, including the compensation allowed by the court to the Trustees for their services hereunder, shall be a charge upon the trust estate and shall be paid by the trustees in full out of the principal or in full out of the income of the trust estate, or partially out of each of them, in accordance with the provisions of the Principal and Income Act from time to time existing, which shall also govern the rights of the beneficiaries among themselves as to principal and income. The determination exercised in good faith of the Trustees with respect to all such matters shall be conclusive upon all persons howsoever interested in the trust.

(*See* Plaintiffs' Ex. 24, at 16). Thus, irrespective of what was meant by the fifth paragraph of the Eighth Article, Paragraph E nullifies the IRS' contention.

Finally, Section 16312(b)(1) of the California Probate Code, which is based upon section 13 of the Uniform Principal and Income Act, provides that interest paid by the trustee shall be charged against income. *See* Cal. Prob. Code § 16312(b)(1). In following that directive, Plaintiffs were acting within the scope of their discretion by allocating the interest payments to income, rather than principal.

3. Deductibility of Administrative Expenses Paid by the Marital Trust

Finally, Defendant argues that the estate cannot claim a deduction for interest paid by the Marital Trust created under

Willet's Will because the payment of interest from Marital Trust income does not comply with 26 U.S.C. § 2053 and Treasury Regulation § 20.2053-1(c)(2). (*See* United States' Post-Trial Brief, at 1). Specifically, the IRS argues that the property of the estate "did not bear the burden of the payment of these deductions" because the estate was terminated and the assets distributed at the time the interest payment was made. (*See* United States' Supp. Brief, at 2).[7]

In *Altendorf v. United States*, 228 F. Supp. 969, 971 (D. N.D. 1964), the deceased's son, who acted as executor, filed a federal estate tax return and paid the amount of tax reported due. *Id.* at 970. Thereafter, the Commissioner assessed and collected additional taxes by including in the gross estate gifts made by the decedent in contemplation of death. *Id.* The estate closed. The decedent's heirs, however, successfully brought an action claiming that their beneficial interest in the estate had been diminished by the taxes erroneously assessed and collected. The issue presented to the court in *Altendorf* was whether the attorneys' fees and costs incurred by plaintiffs in prosecuting the action could be deducted as an administrative expense. *Id.* The court, holding that they could, made the following observation:

> Had this action been instituted by the executor prior to the closing of the estate, there is no question but that § 20.2053(c)(2) would apply and the attorney's fees allowed as 'administra-

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[7] Although the Court granted Defendant the chance to submit a post-trial brief addressing the limited issue set forth above, he apparently viewed this as his opportunity to raise new and novel arguments he neglected to raise in the Motion for Summary Judgment, the Memorandum of Contentions of Fact and Law, and at Trial. Defendant is mistaken. The other arguments raised in Defendant's supplemental brief will not be considered.

> tion expenses.' This Court thinks these Plaintiffs should not be unjustly penalized merely because they brought this action as a class rather than the executor having brought it in his official capacity prior to closing the estate. It would be unrealistic to hold otherwise.

Id. At 971.

Altendorf was cited by the Fifth Circuit in *Pitner*, a case which held that it was not necessary for a probate estate *to even exist* for heirs of the decedent to obtain administrative cost deduction against the taxable estate. *See Pitner*, 388 F.2d at 660 ("If the litigation in which the expenses were incurred facilitated the distribution of the property to the persons entitled to it then the expenses come within the statute."). In *Pitner*, the Court noted that "whether those costs are actually paid from the fund comprising the estate prior to the closing of the estate, or are deducted in a theoretical sense, the estate having already been closed and distributed, is not controlling." *Id.* at 657.

In this case, the Marital Trust paid the estate tax and interest in 1998 because the probate executors had been discharged. In light of the cases cited above, the Court concludes that the interest payments are properly deducted from the gross estate, even though the estate had closed at the time such payments were made. To hold otherwise would unfairly punish the Trustees for the timing of the IRS' Deficiency Notice.

CONCLUSION

For the reasons set forth above, the Court concludes that Plaintiffs are entitled to a deduction in their estate taxes in the amount of $67,246.03. The estate incurred this amount in excess administrative expenses which were both necessary and reasonable, and these expenses were charged against marital bequest income. As for the remaining excess administrative expenses, because the estate charged these expenses to principal, any deduction due to Plaintiffs is offset dollar-for-dollar by the corresponding reduction in the marital deduction.

The estate is also entitled to a deduction for interest payments due by way of the deficiency notice, without a corresponding reduction in the marital deduction. Because the equation for determining the estate's tax liability is complex, the IRS has stipulated to re-compute the federal tax liability based upon this Order. Accordingly, the parties are hereby **ORDERED TO MEET AND CONFER** and submit, no later than close of business on **Monday, October 22, 2001**, a **JOINT PROPOSED FINAL JUDGMENT**, setting forth the estate's tax liabilities in light of the Court's June 28, 2000 Order Regarding Cross-Motions for Summary Judgments, and the findings of fact and conclusions of law set forth herein.

IT IS SO ORDERED.

DATED: October 3, 2001

/s/ Gary Feess
Judge Gary Allen Feess
United States District Court

APPENDIX E

E-1

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

THIS CONSTITUTES NOTICE OF ENTRY
AS REQUIRED BY FRCP, RULE 77(d)

ENTERED
CLERK, U.S. DISTRICT COURT
JUN 29 2000
CENTRAL DISTRICT OF CALIFORNIA
BY /s/ (initials) DEPUTY

FILED
JUN 29 2000
CLERK, U.S. DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA
BY /s/ (initials) DEPUTY

BETTY R. BROWN, MICHAEL J. BROWN, PHILLIP A. MELROSE, BERYL RACE and RAYMOND C. SANDLER, as Co-Trustees of the MARITAL TRUST CREATED UNDER THE WILL OF WILLET H. BROWN;

Plaintiffs,

v.

UNITED STATES OF AMERICA;

Defendant.

Case No. CV 99-5437 GAF (JWJx)

ORDER REGARDING CROSS-MOTIONS FOR SUMMARY JUDGMENT AND PLAINTIFFS' MOTION FOR ORDER PURSUANT TO FEDERAL RULE OF CIVIL PROCEDURE 54(b)

✓ Docketed
✓ Copies / NTC Sent
No JS - 5 / JS - 6

I.
INTRODUCTION AND SUMMARY

Willet and Betty Brown were married in 1948. For reasons unknown and immaterial to this case, they entered into a prenuptial agreement that provided that property each acquired during the marital relationship would be held as their separate property. Years passed, their relationship endured, and they became quite wealthy. However, all of the wealth of their family was accumulated as Willet's separate property and was destined to be included in his estate. Thus, in 1991, when Willet was 87 and Betty 71, Willet and his long-time financial advisor developed a strategy for addressing a number of estate planning issues which appear to have been based on the reasonable assumption that Betty would survive Willet.

First, they created an insurance trust to purchase and hold life insurance on Betty's life, presumably for the purpose of paying estate taxes upon her death. Willet gave Betty a gift of approximately $3,100,000, which was deposited into Betty's separate checking account. Betty in turn wrote a check in the same amount and donated it to the trust which used the funds to buy a $10 million insurance policy on Betty's life.

The gift to the trust fund was a taxable event. Because gift taxes paid by a donor within three years of the donor's death are included in the donor's estate, Willet and his advisor devised a strategy for having Betty pay the gift taxes, making, in their terms, an "actuarial bet" that it was more probable that Betty would survive three years than would Willet. Thus, a second transfer of funds was made to Betty, which she then used to pay the taxes on a number of gifts made by Willet. Some months after these transactions were consummated, Willet died.

Not surprisingly, a dispute ensued with the Internal Revenue Service over who really paid the gift taxes. The IRS took the position that, in reality, Willet paid the gift taxes using Betty as a conduit. Therefore, the IRS included the gift taxes in Willet's estate. The executors of Willet's estate took the position that, even though the gift taxes were drawn from money Willet had recently given to Betty, those funds were deposited into her separate property bank account over which she had sole control. Thus, they contend that, even though the transactions were structured to avoid an increased tax liability to Willet's estate, the transactions had legal substance because Willet gave up control over the funds used to pay the taxes. The question to be decided is whether Betty actually paid the tax in substance, not simply in form.

For the reasons set forth below, the Court finds that the 1992 gift taxes were actually paid by Willet Brown. Accordingly, the Court GRANTS the Government's Motion for Summary Judgement and DENIES Plaintiffs' Motion for Summary Judgment on the First Cause of Action. The Court DENIES the Government's Motion for Summary Judgment on the Second Cause of Action and REOPENS discovery. Finally, the Court DENIES Plaintiffs' Motion for Order Under Rule 54(b) as moot.

II.
FACTUAL BACKGROUND

A. The Relevant Parties

Willet H. Brown and Betty Rhodes Brown were at all relevant times citizens of the United States and residents of California. (PSUF 3; DSUF 1.) They were married in 1948 and were husband and wife until Willet Brown died in 1993. (PSUF 1; DSUF 1.)

Raymond C. Sandler was the legal representative of Willet Brown since approximately 1941 and was an attorney for both Browns in 1992. (PSUF 4; DSUF 2.) For over 20 years Sandler has specialized in estate planning. (DSUF 2.) Prior to 1992, Sandler had done extensive estate planning for Willet, including preparation of a will and various trusts. (PSUF 5.)[1]

Willet Brown died on October 4, 1993. (PSUF 22.) Plaintiffs were appointed co-executors of his last will and testament on January 3, 1994, and acted as co-executors until September 26, 1997. (*Id.*) On December 12, 1994, Plaintiffs were also appointed co-trustees of the Marital Trust Created under Willet Brown's will (the "Marital Trust"). (PSUF 23.) Plaintiffs remain co-trustees. (*Id.*)

B. The Browns Retain Separate Property

Willet and Betty Brown signed a prenuptial agreement on September 27, 1948, which provided that all property acquired by Mrs. Brown after the marriage, from whatever source, would be her separate property, under her control, and freely disposable by her. (PSUF 2.)

The Browns maintained separate bank accounts. (PSUF 16.) Thus, despite the "total gross estate" of Willet Brown being over $180 million, and living in a community property state, nearly all of the marital assets were owned by Willet Brown as separate property. (DSUF 26.) Betty Brown did not have sufficient funds in her account to pay the gift taxes on the $3 million gift to the trust (discussed below) and the other gifts. (PSUF 16.)

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[1] Brown Betty considered Willet Brown and attorney Sandler to be the two men in her life, and she "trusted both of the men in [her] life" to take care of the Brown's business. (DSUF 14.)

C. The Browns Create an Insurance Trust

As part of his estate planning, Sandler discussed with Willet Brown no later than October 16, 1991, "the possibility of helping to meet the federal estate obligation through life insurance on Betty's life." (DSUF 3.) No later than April 27, 1992, Sandler advised that "'[i]f the split dollar insurance is unavailable, it would be necessary for you to fund the cost by gift to an insurance trust. . . . The total cost of a $10 million insurance policy, if paid in a single payment, is $2,923,700.'" (DSUF 3.)

Thus, on or about September 2, 1992, the Browns created an irrevocable insurance trust ("Trust") for the benefit of the children of Willet Brown from a prior marriage and for the Brown's child. (DSUF 5-6, 12; PSUF 8.)[2] The Trust instrument provided for a gift to the trust of $3,102,000 that was used to purchase $10 million in life insurance policies on the life of Betty Brown. (PSUF 8, DSUF 12.)

D. The $3 million Gift to the Trust

Prior to creation of the Trust, Sandler stated to Willet Brown that Mr. Brown could write Mrs. Brown a check for the approximately $3 million to fund the Trust and that she, in turn, could write the check to the trustees, thereby making her the donor of the trust. (DSUF 7.) Sandler further "recommended to [Willet Brown] that he should not pay the gift taxes, that the gift taxes should be paid by Betty Brown." (*Id.*)

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[2] Willet Brown executed the document on September 2, and Betty Brown on September 4, 1992. (PSUF 8.)

Accordingly, on September 3, 1992, decendent Willet Brown signed a check for $3,102,000 payable to Betty Brown. (DSUF 8; PSUF 9.) The check was drawn against funds held in an account that was Willet Brown's separate property. (DSUF 8.) That day, the check was deposited into Betty Brown's personal account by Willet Brown's secretary, Beryl Rae. (DSUF 10; PSUF 9.)[3]

On September 4, 1992, Betty Brown, at Sandler's office, first saw the Trust documents.[4] (DSUF 11.) She signed the Trust and a check for $3,102,000, drawn on her personal account, and handed the check to Sandler. (DSUF 11; PSUF 9.)[5]

E. The Gift Transaction Was Structured So As To Minimize Estate Taxes

Sandler suggested this two step transaction because he was aware of Private Ruling 92-14027, which he understood to mean that if a wife paid gift taxes arising from a joint gift by the wife and husband, and the husband died within three years, the gift taxes would not be included in the decedent husband's estate; however if the wife died within three years, the gift

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[3] The parties dispute whether Mrs. Brown actually endorsed the check. The Court notes that the check itself shows no signature. (Sandler Dec., Exh. B.) This dispute is immaterial because there is no dispute that the money was deposited into Mrs. Brown's separate property account.

[4] Sandler's only conversation with Betty Brown regarding the Trust was "on a very friendly basis" and lasted 10 or 15 minutes. (DSUF 11.)

[5] Mrs. Brown did so at her husband's request. (DSUF 11.)

taxes would be included in her estate. (PSUF 6.)[6] Sandler concluded that the source of the wife's funds by which she paid gift taxes would not be relevant to the effect of Private Ruling 92-14027 so long as the wife freely paid gift taxes from her property, over which she had control. (PSUF 7.)

Based on this understanding, Sandler discussed with Willet Brown that, because he was 87 and his wife was 71, it was more probable that he would die within three years of payment of the gift taxes than that his wife would die within such three years. (PSUF 12; *see* DSUF 22.) Sandler advised Mr. Brown that there were three alternatives that could occur if Mrs. Brown paid the gift taxes on the gift to the trust and the other split gifts:

(a) If neither Brown died within three years, there would be no federal estate tax consequences.

(b) If Mrs. Brown died within three years of paying the gift taxes, the amount of the gift taxes would be included in her estate.

(c) If Mr. Brown died within three years of his paying the gift taxes, there would be no tax consequences to his estate.

(PSUF 13.) Sandler discussed with Mrs. Brown that, in essence, the Browns would be making an actuarial bet that, based solely on their respective ages, Mr. Brown was more likely to die in three years than his wife. (PSUF 14.) Sandler

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[6] While the Government objects to these facts as legal conclusions, Sandler's understanding of the Private Ruling (as opposed to the accuracy of his analysis) is a fact and is relevant insofar as it relates to the Brown's knowledge and intentions.

further discussed with Mr. Brown that he and his wife could have no control over the ultimate estate tax consequences if Mrs. Brown paid the gift taxes. (PSUF 15.) No predetermined result would follow from Mrs. Brown's paying the gift taxes because neither Brown would know which of them, if either, would die within three years of the gift tax payment. (PSUF 15.)

However, Sandler explained to Mr. Brown that in order for Mrs. Brown's payment of the gift taxes to be deemed to have been paid by her, payment would have to come from funds over which she had control. (PSUF 17.) Sandler further explained that result would come only if Mr. Brown made an unconditional gift to his wife. (*Id.*) Thus, Mr. Brown would have to trust his wife to make payment of the gift taxes. (*Id.*) Sandler further explained to Mr. Brown that if his wife made a legally binding promise or representation that she would use the proceeds of his transfer of funds to pay the gift taxes, the transfer of funds to her would not be regarded as a gift. (*Id.*) Mr. Brown acknowledged to Sandler his understanding that money transferred by him to his wife would be in essence "with no strings attached." (PSUF 18.)[7]

F. Payment of the Gift Taxes on the $3 Million

Based on Sandler's advice, when Mr. Brown signed a check for $3,102,000 payable to his wife on September 3, 1992, there was an "understanding" between the Browns that Betty Brown would use that money to fund the Trust. (DSUF

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[7] While the Government objects to this fact as inadmissible hearsay, it is proper to show Willet Brown's state of mind.

9; 15-16.)[8] Betty Brown in fact used all the money for that purpose by transferring it to the Trust the next day, September 4, 1992. (DSUF 16.)[9] In addition, on September 22, 1992, Sandler sent a letter to Jay Bieber ("Bieber"), Certified Public Accountant ("CPA"), with a copy to Willet Brown, stating that they should "arrange" for Betty Brown to pay the gift taxes because of "the rule that the amount of the gift tax is includable in the estate of the donor who pays the tax if the donor dies within a 3-year period. . . . In filing the gift tax return, Betty Brown should join and should probably pay the applicable tax for the reasons stated above." (DSUF 12.) In other words, Sandler concluded that if Mrs. Brown paid the gift taxes on the gift to the trust and on other split gifts, the gift taxes would not be included in Willet Brown's estate if he died first, even if his death occurred within three years of payment. (PSUF 11.) Thus, no later than September 22, 1992, Sandler recommended to Willet Brown that his wife pay the gift taxes due on April 15, 1993. (DSUF 13.)

Betty Brown owned insufficient assets to pay her reported gift tax liability. (DSUF 26; PSUF 16.) Thus, on April 13, 1993, Willet delivered to Betty two checks made payable to her in the amounts of $1,414,000 and $1,732 with the "understanding" between the Browns that Betty Brown would

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[8] It is undisputed that Mr. and Mrs. Brown had an "understanding" insofar as they mutually contemplated that they would follow their attorney's estate planning advice regarding how to structure the gift transaction. Pl's Response to DSUF 9; *see also* Brown Depo. pp. 29-31 (Betty Brown understood she was "expected" to write a check for $3,000,000 to Trust upon deposit of $3,000,000 check that Willet gave her, but that she "never thought about" and "didn't think about" whether she could have done something else with the money).

[9] Betty knew that Willet transferred the $3,102,000 to her on September 3, 1992, for the purpose of funding the Trust. (DSUF 17.)

use that money to pay gift tax liabilities of the Browns. (PSUF 19; DSUF 23-24, 29-30.)[10] The checks were again drawn from an account that was Willet Brown's separate property. (DSUF 23.) The checks were deposited into Betty Brown's personal account by Willet Brown's secretary, Beryl Rae. (PSUF 19; DSUF 25.)

On April 14, 1993, Betty Brown, pursuant to Mr. Brown's, Sandler's, and CPA Bieber's instructions, signed two separate checks for $707,866 (*i.e.*, total amount $1,415,732) drawn from her personal account payable to the IRS and sent the checks to pay the $1,415,732 gift taxes which she was advised were due. (PSUF 20; DSUF 27, 30.)

G. The Browns' Gift Tax Return Statements

On April 14, 1993, Mr. and Mrs. Brown each filed a separate United States Gift Tax Return (Form 709) for the calendar year 1992 with the IRS. (PSUF 21; DSUF 28.) They elected under Internal Revenue Code §2513(a) to treat the "gifts" reported therein as made one-half by Mrs. Brown and one-half by Mr. Brown for federal gift tax purposes. (PSUF 10, 21.) As a consequence of the elections, the Browns reported to the IRS that each owed $707,866 in gift taxes; and the combined liability was $1,415,732. (DSUF 28.)

On October 14, 1993, six months later, Willet Brown died. (DSUF 31.)

H. The Willet Brown Estate Tax Return

On January 13, 1995, Plaintiffs, in their capacity as co-executors of the Estate of Willet H. Brown filed a the U.S.

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[10] *See* n. 8, *supra.*

Estate Tax Return (IRS Form 706) with the IRS, which reported a gross estate of $181,801,820 and no estate taxes as due and/or payable. (PSUF 24; DSUF 32.) The return reported no estate taxes were due based on Plaintiffs' understanding that, under Mr. Brown's will, the entire net estate qualified as a marital deduction under the provisions of §2056 of the Internal Revenue Code of 1986, as amended. (PSUF 24.)

On September 26, 1997, the Superior Court of Los Angeles County rendered its Order for Final Distribution, which provided among other things that Mr. Brown's residual estate be distributed to Plaintiffs in their capacity as co-trustees of the marital trust. (PSUF 25.)

On January 5, 1998, the IRS sent to Plaintiffs, in their capacity as co-executors of Willet's estate, a Notice of Deficiency (90-day letter) asserting a deficiency in the federal estate taxes of $1,663,650, based upon the contention that gift taxes in the amount of $1,415,732 paid by Betty Brown on April 15, 1993 were actually paid by Willet Brown, and therefore should have been included under Schedule G, Form 706 as a transfer during his life in accordance with provisions of §2035(c) of the Internal Revenue Code (PSUF 26; DSUF 33.) On January 28, 1998, Plaintiffs, in their capacity as co-trustees of the marital trust, remitted the sum of $2,096,107 to the IRS as full payment of the estate taxes claimed to be due in the principal sum of $1,474,664 and accrued interest of $621,443. (PSUF 27.)

On May 18, 1998, the IRS made the following assessments against the Estate: (1) "Audit Deficiency tax assessed" in the amount of $1,663,650; and (2) "Interest" assessed in the amount of $620,316.06. (DSUF 34.) In a letter dated June 10, 1998, the IRS allowed an additional

credit for state death taxes allowable in the amount of $188,986, and the IRS determined that the "Net Estate Tax" liability was $1,474,464.00. (DSUF 35.) Because the IRS determined that the Estate overpaid the amount of interest due on the Federal estate tax deficiency the IRS, on July 13, 1998, sent a refund to Plaintiffs in the amount of $71,593.11, leaving a balance of $1,474,664 in estate taxes paid and $549,850 in interest paid, for a total of $2,024,514 paid by Plaintiffs. (DSUF 35; PSUF 28.)

I. Plaintiffs' Claim for Reimbursement

On October 13, 1998, Plaintiffs filed an IRS Form 843 "Claim for Refund and Request for Abatement" with the Commissioner of Internal Revenue. (DSUF 36; PSUF 29.) Plaintiffs claimed a refund in the amount of $2,024,514, being the total amount of federal estate taxes and interest paid by Plaintiffs, and demanded refund and repayment of said sum together with interest as provided by law. (PSUF 29.)

After more than six months had elapsed from the time Plaintiffs filed their claim for refund, Plaintiffs still received no response from the Commissioner of Internal Revenue. (PSUF 30.) No part of the sum claimed has been credited, refunded, or repaid to Plaintiffs or to anyone for their account. (PSUF 30.)

Plaintiffs filed their Complaint For Recovery of Federal Estate Taxes and Interest Erroneously and Illegally Collected on May 25, 1999, over seven months after they filed their claim for refund, and over one year after they paid the estate taxes and interest claimed to be due by the IRS. (PSUF 31.)

III.
LEGAL ANALYSIS R: CROSS MOTION FOR SUMMARY JUDGMENT AS TO FIRST CAUSE OF ACTION FOR RECOVERY OF ESTATE TAXES

The Government asserts that, for purposes of assessing estate taxes, Willet Brown's estate should include the amount of gift taxes paid in 1992 because, in reality, Willet Brown (not Betty Brown) paid the gift taxes.

As an initial matter, the Court notes that there is nothing in this case that suggests that the Browns had an unlawful intent to evade taxes. The Court agrees with Judge Learned Hand that

> "anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes . . . ."

See Grove v. Commissioner, 490 F.2d 241, 242 (2d Cir 1973) (citing *Helvering v. Gregory*, 69 F.2d 809, 810 (2nd Cir. 1934), *aff'd* 293 U.S. 465 (1935)). Thus, the issue to be decided here does not call for the Court to make a judgment regarding the propriety of actions by the Browns or Sandler. Rather, the Court must simply answer the question: who paid the gift taxes? If Willet Brown actually paid the taxes, then the Government was correct in including the amount of taxes in his gross estate; if he did not, then Plaintiffs are entitled to a refund. To determine the actual payor, the Court looks to the substance, not form, of the transaction. *See Diedrich v. Commissioner*, 457 U.S. 191, 195, 102 S. Ct. 2414, 2417, 72 L. Ed. 2d. 777 (1982).

A. Relevant Tax Law

1. Willet and Betty Brown Were Jointly and Severally Liable for the Gift Taxes

Pursuant to the Tax Code, spouses may agree that, for tax purposes, gifts made by one spouse will be considered as being made equally by both spouses. 26 U.S.C. § 2513(a). When spouses so elect, they will be jointly and severally liable for the gift taxes. 26 U.S.C. § 2513(d). Here, Willet and Betty Brown elected to treat all gifts made in 1992 as though they were made by both them equally. Accordingly, regardless of who actually gave the $3 million to the Trust, Willet and Betty were jointly and severally liable for the gift taxes.

2. Gift Taxes Will Not Be Included in Estate If Paid By Decedent's Spouse Under § 2513

As a general rule, the amount of gift taxes paid by the decedent within the three years preceding his or her death is included in the decedent's estate for estate tax purposes. 26 U.S.C. § 2035(c). However, if the decedent's spouse pays the tax on gifts deemed jointly made under Section 2513 from his or her separate property, the amount of the gift tax payments will not be added to the decedent's estate. *See Estate of Sachs v. Commissioner*, 855 F.2d 1158 1165 (8th Cir. 1988).

B. The Gift Taxes[11] Were Paid By Willet Brown Through A Step Transaction

There is no dispute that Willet Brown gave Betty Brown the exact amount of money to pay the gift taxes the day before the taxes were due. Nevertheless, Plaintiffs assert that the gift taxes were paid by Betty Brown because the checks were drawn on her separate bank account. Plaintiffs argue that, because there was no binding agreement for Mrs. Brown to use her husband's "gift" to her to pay the taxes, she is the legal payor of the gift taxes. The Government counters that, although the money was drawn from Mrs. Brown's account, under the "step transaction" doctrine, Willet Brown was the payor of the gift taxes.

Under the "step transaction" doctrine, a series of related transactions will be treated as one transaction, even though they are formerly separate, if all steps are sufficiently linked. *See Commissioner v. Clark*, 489 U.S. 726, 738, 109 S. Ct. 1455, 1462-63, 103 L. Ed. 2d 753 (1989); *see also Greene v. United States*, 13 F.3d 577, 583 (2nd Cir. 1994). There are three tests which may be used to determine whether a series of transactions is a step transaction – "binding commitment," "end result" and "interdependence." *See Kornfeld v. Commissioners of Internal Revenue*, 137 F.3d 1231, 1235 (10th Cir. 1998).

1. The Binding Commitment Test

Plaintiffs rely on the binding commitment test to argue that Betty Brown paid the gift taxes. Under the binding commit-

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[11] Only the 1.4 million paid in gift taxes is at issue here. Thus, beyond providing context for the gift tax at issue, the question of who made the $3 million gift is irrelevant.

ment test, "'if one transaction is to be characterized as a "second step" there must be a binding commitment to take the latter steps.'" *Brown v. United States*, 782 F.2d 559, 564 (6th Cir. 1986) (citing *Commissioner v. Gordon*, 391 U.S. 83, 96, 88 S. Ct. 1517, 1524-25, 20 L. Ed. 2d 448 (1968)). Thus, when payment of taxes is an absolute condition of giving a gift, the donor will be considered the tax payor for purposes of calculating the estate taxes. *See Estate of Sachs*, 856 F.2d at 1164 ("donee's tax payment (on a gift made within three years of the donor's death) is an includable part of the donor's gross estate"). Of all three tests, this is the most restrictive and rarely applied. *See Brown*, 782 F.2d at 564; *see also Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1522 n.6 (10th Cir. 1991).

Plaintiffs correctly note that there was no binding agreement for Betty Brown to use her husband's "gift" to her to pay the 1992 gift taxes. Pursuant to the prenuptial agreement, once the money was deposited in her account, it was her separate property. Thus, Plaintiffs are correct that the transactions here were not step transactions under the binding agreement test. However, Plaintiffs' argument that this is dispositive ignores the fact that there are two other tests to determine if there is a step transaction. *See True v. United States*, 190 F.3d 1165, 1175 (10th Cir. 1999) (circumstances need only satisfy one step transaction test in order for rule to apply).

2. *The "End Result" Test*

Under the end result test, "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." *Brown*, 782 F.2d at

563-64 (internal citation omitted); *see, also Greene*, 13 F.3d at 583. Intent to achieve a certain result is a necessary element. *Brown*, 782 F.2d at 564. However, the "pre-arranged plan" need not be a formal agreement; it is sufficient to show an informal agreement or understanding. *Greene*, 13 F.3d at 583.

a. The End Result of these Transactions was for Willet Brown to Pay the 1992 Gift Taxes

The facts here show that the intent of the Browns was for Willet Brown to pay the gift tax through his wife. Indeed, Plaintiffs admit that there was an informal agreement between Betty and Willet Brown for Betty Brown to pay the gift taxes with the money that Willet Brown was giving her. *See, e.g.*, Plaintiffs' Response to DSUF 9. Thus, this case is distinguishable from *Grove v. Commissioner*, 490 F.2d 241 (2nd Cir. 1973), and other cases cited by Plaintiffs, in which there was no formal *or informal* agreement for the third party act in any manner. *See also Blake v. Commissioner*, 697 F.2d 473 (2d Cir. 1982) (even informal agreements may condense multiple transactions into one). In *Blake*, the Second Circuit stated:

> Even if [the] understanding fell short of a legal obligation, it amounted to more than mere wishful thinking on the taxpayer's part and thus refutes the contention that these transactions were merely coincidental.

Likewise, here, the transactions cannot reasonably be said to be "merely coincidental." Prior to April 1993, Betty Brown did not have the money to pay the taxes. The day before the

taxes were due, Mr. Brown wrote checks in the exact amount of the tax liability due and owning. Mr. Brown's secretary deposited the checks into Mrs. Brown's account, and it appears that Mrs. Brown never saw them. Mrs. Brown, within a matter of a day or two, at most, wrote checks drawn on her account made payable to the IRS to cover the gift tax liability. Mrs. Brown admits that she never considered that she could do anything else with the money except pay the IRS. Indeed, given the short time she spoke to Sandler, it is doubtful that Mrs. Brown even understood the nature of the transaction.[12]

b. The Byrum Decision Does Not Require A Different Result

Citing to *United States v. Byrum*, 408 U.S. 125, 92 S. Ct. 2382, 33 L. Ed. 2d 238 (1972), Plaintiffs assert that the 1992 gift taxes should not be included in Mr. Willet's estate because Betty Brown had legal control over the money used to pay the taxes. In *Byrum*, the decedent transferred stock in closely held corporations for which the decedent was a majority shareholder. Upon the decedent's death, the IRS asserted that the transferred stock should be included in the decedent's estate under 26 U.S.C. § 2036 (transfers with retained life estates). Under that statute, a gross estate should include all property which the decedent had transferred but for which he or she has retained the possession of the gift, the right of income from the gift, or the right to designate the persons who will possess the property or the income therefrom. 26 U.S.C. § 2036(a)(1) and (2). The question before the Court was whether, as majority shareholder in the corporations, the

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[12] *See* DSUF 12 (that the lawyer and accountant were "arranging" for Betty to pay the taxes indicates that she made no independent judgments with respect to payment).

decedent retained legal control over the transferred stock and/or its income. The IRS argued that the decedent's position was "'tantamount' to a grantor-trustee's power to accumulate income in the trust," and thus was includable in his estate. *See Bryum*, 408 U.S. at 132, 92 S. Ct. at 2388. The Court disagreed, finding that the corporate trustee alone had the right to pay for withhold income, and that the decedent's power to elect directors did not confer the right to pay dividends. *Id.* at 137-38, 92 S. Ct. at 2391. Indeed, in that case, the decedent and the directors he elected had a separate legal duty to promote the interests of the corporation, not the interests of a trust's beneficiaries. *Id.*

Byrum is not applicable here because Section 2035 does not require Mr. Brown to have legal control of the tax money at all times in order for him to be deemed the payor. Rather, Section 2035 allows the Court to go beyond the form of a transaction to determine who in fact paid the tax. *See Sachs*, 856 F.2d at 1164. legal control over the funds falls out of the analysis because the "'result [achieved] at the end of a straight path is not made a difference result because reached by following a [circuitous] one.'" *See Sachs*, 856 F.2d at 1164 (quoting *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 58 S. Ct. 393, 82 L. Ed. 474 (1938) (editions added)). Thus, the Court looks to agreements between the parties, whether or not legally binding, to assess the true nature of the transaction. *Blake*, 697 F.2d at 478-79.

Here, the plan to have Mrs. Brown pay the gift taxes was first made in September 1992. Plaintiffs admit that the Browns had an agreement for Mrs. Brown to pay the gift taxes through money given to her by Mr. Brown. A realistic view of the transactions here evidences that, in substance if not form, Mr. Brown paid the gift tax. Thus, the amount of the tax was properly included in his estate.

3. The Interdependence Test

Related to the end result test is the interdependence test. This test looks to whether the transactions were "'so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.'" *Greene*, 13 F.3d at 584 (quoting *American Bantam Car Co. v. Commissioner*, 11 T.C. 397, 405, 1948 WL 50 (1948)). Under this test, the Court looks at whether "'it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts.'" *True*, 190 F.3d at 1175 (quoting *Kuper v. Commissioner*, 533 F.2d 152, 156 (5th Cir. 1976)).

Here, Betty Brown did not have the resources to pay the gift taxes but for the "gift" from her husband. While each step of the transaction had independent legal significance, it is obvious to the Court that Mr. Brown would not have given his wife a "gift" of exactly the amount of taxes due, the day before the taxes were due, unless he contemplated that she would use the money to pay the tax. Mrs. Brown's payment of the gift tax was clearly interdependent with Mr. Brown's gift to her, thus evidencing the step transaction.

IV.
LEGAL ANALYSIS RE: GOVERNMENT'S MOTION FOR SUMMARY JUDGMENT ON THE SECOND CAUSE OF ACTION FOR OFFSET TO ASSERTED DEFICIENCY FOR ADMINISTRATIVE EXPENSES

Plaintiffs' Second Cause of Action seeks to offset any deficiency by incurred administrative expenses. In moving for summary judgment on this claim, the Government assert that Plaintiffs have no evidence of administrative costs not already

claimed. In opposition, Plaintiffs submit a declaration outlining the costs and attaching documents. The Government objects that it would be prejudiced by the Court's consideration of these documents because these documents were not previously disclosed, and the Government would need additional discovery to determine the reasonableness of the costs.

The Court finds that the Government should be given the opportunity to review the newly produced evidence and conduct further discovery if necessary. Recognizing that the discovery cutoff has past, the Court will reopen discovery.

V.
LEGAL ANALYSIS RE: PLAINTIFFS' MOTION FOR ORDER UNDER RULE 54(B)

Plaintiffs' motion for an order under Rule 54(b) on its Second and Third Causes of Action was conditioned on the Court's granting of their motion for summary judgment on the First Cause of Action. Having denied Plaintiffs' motion for summary judgment, the Court DENIES the Rule 54(b) motion as moot.

VI.
CONCLUSION AND ORDER

As to the First Cause of Action, the Court GRANTS the Government's Motion for Summary Judgment and DENIES Plaintiffs' Motion for Summary Judgment. The evidence shows that, in paying the gift taxes, Willet and Betty Brown both intended for Willet Brown to pay the taxes through Betty Brown. As such, under Section 2035, the amount of the gift taxes is includable in Willet Brown's estate.

As to the Second Cause of Action, the Court DENIES the Government's Motion for Summary Judgment without prejudice to filing a future motion once discovery has been taken. The Court further orders that discovery is REOPENED until August 28, 2000. All other relevant dates are set forth in the Court's June 26, 2000 Minute Order.

Plaintiffs' Rule 54(b) motion is DENIED as moot.

IT IS SO ORDERED.

DATED: June 28, 2000

/s/ Gary Feess
Judge Gary Allen Feess
United States District Court